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July/Aug 1981 AEI Journal on Government and Society

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Michael Sohn and Robert Litan

Making Law without Making Rules

Antonin Scalia

Wasting Our National Forests

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The Cost of Getting Nowhere at the FTC

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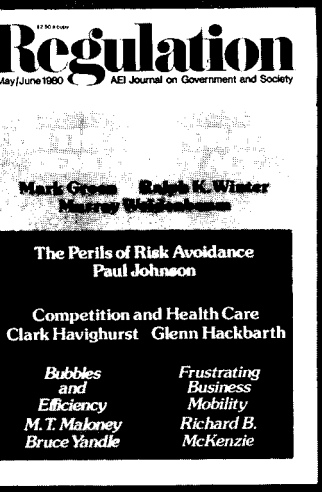

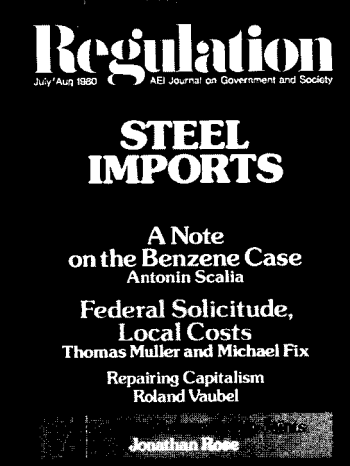

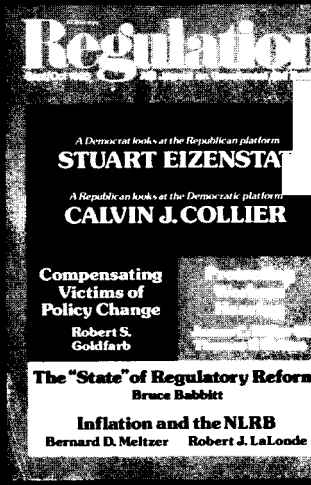
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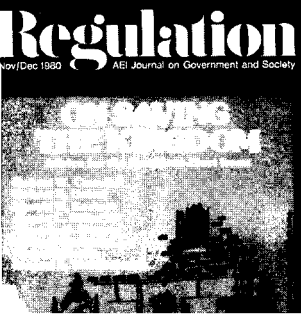

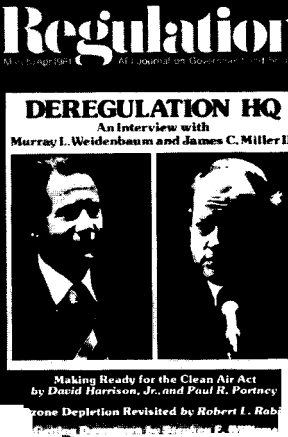
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Making Ready for the Clean Air Act
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Regulation

July/Aug 1981 AEI Journal on Government and Society

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REGULATION, *July/August 1981, Vol. 5, No. 4. Published bimonthly by the American Enterprise Institute for Public Policy Research.* *Copyright 1981 American Enterprise Institute.* *Subscription rates: $12 for one year, $22 for two years (add $2 per year for foreign subscriptions). Single copy price, $2.50. Information on bulk orders or multiple subscriptions available on request. Editorial and business offices: c/o AEI, 1150 17th Street, N.W., Washington, D.C. 20036. Send changes of address and all subscription correspondence to Circulation Department, c/o AEI, same address.*

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Highway Congestion Pricing

TO THE EDITOR:

Being one of those economists who has contributed to the clutter in professional journals of articles dealing with theoretical underpinnings of congestion pricing, I read with considerable enjoyment Stephen F. Williams's eloquent plea for a pricing solution to urban traffic congestion (*Regulation*, March/April). What disagreements I have with Williams's article stem entirely from an apparent disagreement between us about the political feasibility of congestion pricing. That a benevolent autocrat, Lee Kwan Yew, was able to impose an imperfect but enormously successful congestion-pricing scheme on downtown Singapore without inciting rebellion is no guarantee that an American mayor, governor, or president could do so; beneficial though congestion pricing would be, I seriously doubt that it is in the cards for the United States or, for that matter, for any but the most unusual of democratically governed societies.

Perhaps because of a political judgment that congestion pricing really is feasible in the United States, Williams gives short shrift to such traffic control measures as reserved lanes on city streets and preferential access ramps to expressways for buses and other high-occupancy vehicles. He dismisses these traffic-control schemes on the grounds that "queuing rations access to users who are most willing to *throw away* a valuable resource (time)." *My* political judgment, coupled with independent analyses that Kenneth Small and I have done of traffic flows, leads me to take these traffic management schemes much more seriously.

The case for reserved lanes and preferential access requires a brief excursion into the theory of "second-best" congestion pricing. "Second-best" prices are those that should be charged if for some reason "first-best" (that is, marginal cost) prices cannot be charged. The "full price" of a highway trip can usefully be defined as the sum of a traveler's cash outlays for vehicle operation, tolls, bus fares, and the like plus the value to the traveler of the time it requires—the amount he would be willing to pay to save that time. A basic proposition of second-best congestion pricing is that if the cash component of the price of a trip must for whatever reason be lower than that of the optimal price, then the time component of the price should be higher than that of the optimal price. In such a situation, expansion of the highway would, it is true, reduce the total time and other resource costs of the equilibrium number of trips. At the same time, however, expansion would encourage additional trips valued by their takers at less than the full costs these trips would impose on society at large. The social costs of these trips would more than offset the social gains from the reduced full prices of individual trips.

One step further: If a traveler has alternative ways—bus and auto, for example—of taking a trip, he will choose that mode which has what is for him the lowest full price. If the time-plus-money cost of an auto trip is less than that of a bus trip, he will go by auto; if the reverse, he will go by bus. As Williams suggests, current prices for highway use are far below the optimal marginal-cost prices. As a result, too many travelers use autos; if more travelers could be induced to shift to buses, the total time and other resource costs of a given number of trips would fall. If it is impossible to establish marginal-cost prices for highway use, the second-best way of effecting such a shift is to increase and decrease respectively the time components of the full prices of auto and bus trips from what they would be with both modes given equal access to capacity. One way of doing this is to provide reserved lanes on city streets and preferential access to expressways for buses and other high-occupancy vehicles. My calculations, based on a representative Minneapolis arterial street during rush hour, suggest that a reserved bus lane could capture about three-quarters of the benefits that would be gained from complete marginal-cost pricing. Small gets similar results for preferential access by high-occupancy vehicles to San Francisco Bay–area expressways.

In a nutshell, then, Williams is quite right in claiming enormous potential benefits for marginal-cost pricing of highway capacity. He is wrong, though, in lightly dismissing such traffic management techniques as preferential access for high-occupancy vehicles. Second-best though they may be, these techniques seem to be surprisingly efficient ways of rationing highway capacity.

Herbert Mohring,
University of Minnesota

TO THE EDITOR:

In response to "Getting Downtown," here are some comments:

(1) Charging a toll for access to downtown in rush hour will do no more good than $3.00-per-gallon gas does for automobile use in Europe and Japan.

(2) The majority of people who enter the downtown areas at rush periods have to do so to report for work on time; they will be penalized for something over which they have no control.

(3) Cost-benefit analysis will show that the cost to those people who must pay is more than the inconvenience of starting earlier.

(4) The answer lies in prohibiting more expansion of the center while encouraging those businesses now in the center city to move out to suburban areas, as well as giving tax benefits to the construction of adequate downtown housing for those who must work there.

(5) Suburban office parks and shopping must be required to locate in areas having sufficient close-by housing for their employees or to subsidize construction or financing of such housing if they choose to move where such housing is not available.

(6) Modern electronic communication facilities make it no longer

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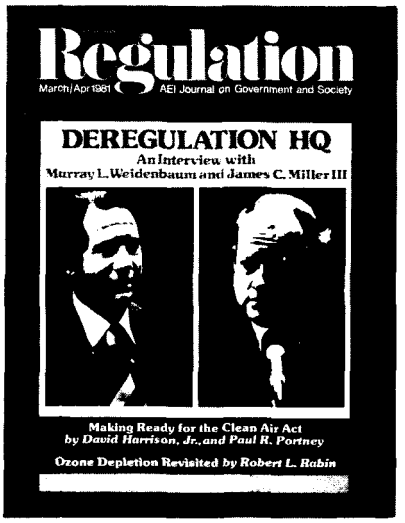
necessary for businesses to be grouped together in a downtown area.

(7) In many areas of our country this suburbanization of business is now in progress with much success. It should be vigorously encouraged.

Henry D. Norris,
Architects Norris & Lynch, Inc.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Ozone Depletion Revisited by Robert L. Rabin

STEPHEN WILLIAMS responds:

Mohring's letter very graciously corrects a false impression my article may have left: that I viewed preferential access for high-occupancy vehicles (HOVs) as no better than the simple queuing that has prevailed on the urban expressway until recently. Clearly they represent a step forward, and Mohring's calculation that they may achieve three-quarters of the benefits of marginal cost pricing is impressive.

For access to the *non*-HOV lanes, preferential access systems retain rationing by queue rather than by price, with the resulting waste of time. And while they provide an incentive for the use of HOVs, they provide none for other behavior that would reduce peak-hour congestion (such as changes in travel time). Thus they fail to squeeze out that last one-quarter of possible benefit.

As to the political feasibility of congestion pricing, who knows? While it is notorious that the best can be the enemy of the good, so can a premature despair.

On Norris's points:

(1) Wouldn't peak-hour congestion rise in Europe and Japan if gasoline cost only $1.30 per gallon? Wouldn't it fall if the price rose to $10 per gallon? The doubling of prices in 1979–80 has clearly reduced gasoline consumption here.

Also, for a car averaging 30 miles to the gallon, the difference between gas at $3 and gas at $1.25 is only 7 cents per mile. Any realistic set of center-city peak-hour tolls would be very considerably higher—more like 30 cents per mile. (That is comparable to $10 per gallon gas.)

(2) But they *do* have control over the decision to carpool or not.

(3) Again, changing time is not the only option. Further, with a well-conceived plan for distributing the pricing proceeds, anyone whose savings in time were less than the value of his new cash expenses would reasonably expect to more than make the loss up in his share of the pricing proceeds.

(4) through (7) Maybe, maybe not. Even well-sprawled cities like Houston and Los Angeles seem to have downtown congestion, so I doubt that changes in urban form would render pricing solutions moot.

Ozone Depletion

TO THE EDITOR:

Robert Rabin ("Ozone Depletion Revisited," March/April 1981) provides an excellent overview of both the continuing chlorofluorocarbon (CFC) controversy and the problems associated with any attempt to implement alternatives to traditional "command-and-control" regulation.

As Rabin suggests, the theoretical advantages of permits are clear. (Here and throughout, I speak only for myself and not for EPA.) Instead of selective bans or separate performance or technology standards for hundreds of different CFC uses—which involve enormous information, administrative, and enforcement burdens—there would be a ceiling on total emissions, producers' or users' permits would be allocated up to this total, and the market would set a clearing price. Recent studies indicate that a permits system designed to hold CFC emissions at current levels would cost industry roughly half the control investment of equivalent performance or emission standards—$100 million versus nearly $200 million.

Unfortunately, the difficulties of implementing permits in the real world are equally clear. They include both allocation and structural problems, as well as agency/industry resistance to the uncertainty of a new approach. Giving permits to current makers or users in accord with a historical baseline would grant them an enormous windfall and might create significant barriers to market entry. An auction of permits could require firms to cough up as much as $2 billion to continue activities now viewed as free. The system must somehow ensure that the same permits are not sold twice. And it must have a mechanism to connect sellers and buyers without prohibitive delays or other transaction costs, if it is to be fully efficient. None of these problems is insoluble, but some government involvement, and a good deal of institution-building, will still be needed.

The important point, which Rabin touches but does not expand upon, is that EPA's bubble policy and other controlled trading approaches *have already accomplished this critical groundwork*, in far more complex areas of the Clean Air Act. Indeed it is not inaccurate to say that controlled trading has made permits possible. At least 1,000 offset transactions for new plants have occurred since January 1978. Three formal banking systems are now operating, with twenty more under development by state and local authorities. EPA has approved or proposed approval of fourteen bubbles saving $40 million. Sixty other bubbles averaging $2 million in savings are being developed by American industry. New Jersey was recently authorized to approve individual bubbles without case-by-case federal review, and fourteen states are developing similar "generic" rules. Several interplant bubbles are also being developed. In May the Illinois Chamber of Commerce inaugurated the first private clearinghouse for buyers and sellers of surplus emission reductions. The agency now projects savings of over $200 million from EPA-approved bubbles this year, and several times that amount if five state "generic" rules are in place by this fall. . . .

These trends should accelerate soon when EPA formally integrates its past policies, streamlining procedures and making controlled trades easier for more firms in more places. The need to make controlled trading work has compelled EPA to start becoming a manager auditing state programs rather than a regulator directly involved in each individual transaction. That shift is crucial for any market-based approach.

(Continues on page 60)

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Perspectives
on current developments

The (Cotton) Dust Settles

In the *Cotton Dust* case *(American Textile Manufacturers Institute* v. *Donovan)*, decided June 17, the Supreme Court finally reached and settled the question whether OSHA's standard on the use of toxic materials in the workplace must be supported by cost-benefit analysis. That issue had been presented but avoided in the *Benzene* case *(Industrial Union Department, AFL-CIO* v. *American Petroleum Institute)*, decided the previous term. As noted in the pages of *Regulation* a year ago, the breakdown of the justices' opinions in that case did not augur well for cost-benefit analysis (see Antonin Scalia, "The Benzene Case," July/August 1980). That augury proved correct. The only justice who had expressed support for a cost-benefit requirement in *Benzene*, Justice Powell, did not participate in *Cotton Dust*, while the four justices who had expressed opposition to such a requirement (Brennan, Marshall, Blackmun, and White) held firm and acquired a fifth justice who had not reached that issue in the earlier case (Stevens). In the final showdown not a single vote was cast in favor of cost-benefit analysis. The three dissenters went off on other grounds, Justice Stewart finding that the rulemaking record did not contain the "substantial evidence" required to support the particular standard OSHA had adopted, and Justice Rehnquist, joined by Chief Justice Burger, maintaining (as he had in *Benzene*) that the statute provided "no meaningful guidance to those who will administer the law," and was thus an unconstitutional delegation of legislative authority.

The basic elements of the controversy were straightforward enough. The definitional section of the statute states that the term "occupational safety and health standard" as used in the legislation means a standard imposing requirements "reasonably necessary or appropriate to provide safe or healthful employment and places of employment." The petitioners asserted that this language establishes a cost-benefit requirement—a plausible assertion, though it is unusual (and sloppy) but not unheard-of to impose major substantive requirements in a definitional section. On the other hand, a substantive section of the law, specifically applicable only to toxic materials and harmful physical agents, requires each standard in that area to be one that "most adequately assures, to the extent feasible, . . . that no employee will suffer material impairment of health." The crucial phrase "to the extent feasible" is hardly the language of cost-benefit analysis: something may be feasible but exceedingly unwise. On the face of it, any inconsistency between the two provisions (assuming that the first imposes a cost-benefit requirement) would seem quite reasonably resolvable by concluding that Congress wanted to depart from analysis-as-usual, and to impose a particularly rigorous requirement, when toxic substances were involved. Unless the legislative history suggested otherwise, that is surely what one would normally conclude. And the legislative history did not suggest otherwise; but rather displayed a clear congressional agreement to disagree as to what in the world the phrase "to the extent feasible" might mean. It is hard to refute the majority's conclusion that the statute does not require cost-benefit analysis in this field.

The Rehnquist dissent focuses upon the fact that if the phrase "to the extent feasible" does not suggest cost-benefit analysis, it also does not suggest much else of any precise content. "[T]hose words mean nothing at all. They are a 'legislative mirage, appearing to some members [of Congress] but not to others, and assuming any form desired by the beholder.'" Moreover, Rehnquist discerns method in the meaninglessness.

> The words "to the extent feasible" were used to mask a fundamental policy disagreement in Congress. I have no doubt that

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> if Congress had been required to choose whether to mandate, permit, or prohibit the Secretary from engaging in a cost-benefit analysis, there would have been no bill for the President to sign.

Rehnquist's observations are probably correct. But one wonders whether they lead to his conclusion that there has been an unlawful delegation of legislative authority. Do they not rather lead to the conclusion that there has been no legislation at all? The doctrine of unconstitutional delegation—as a principle enforceable by the courts—has its difficulties, inviting the courts to make judgments on practicability, necessity, and other prudential matters well beyond their ken. Perhaps for that reason, the doctrine has been applied to invalidate delegation to the executive only twice, in the early days of the New Deal. But might there not be room for another, more limited (and thus more serviceable) doctrine which we might call—for want of a better phrase—the doctrine of illusory legislation?

Suppose the Congress passes, and the President signs, a bill saying, "The secretary of labor may do blzzt." And suppose, further, that the legislative history displays 100 senatorial and 435 representative understandings of what "blzzt" might mean. Only a man from Mars or a lawyer could conceivably conclude that by this provision Congress has made an "unlawful delegation of authority" to the secretary. Surely, to be frank about the matter, Congress has issued no legislative command at all—any more than the President issues an executive directive when he sneezes. Even if the doctrine of unconstitutional delegation is left, as far as the courts are concerned, to lie in the desuetude it has enjoyed since its last Supreme Court application in 1935, might there not be room for a more modest doctrine which affirms the logical, noble, and yet entirely democratic proposition that when Congress says nothing, nothing occurs? Let it be so that when Congress says, "The secretary may enact such standards in this area as tickle his fancy," the courts will not interfere; but when Congress says, "The secretary may do blzzt," the courts will not permit any results to ensue. At least when it is clear, as in the OSHA legislation, that a provision has no meaning *and that Congress knew it had no meaning*, the provision should simply have no legislative effect. Perhaps Rehnquist could enlist greater support for this less ambitious proposition.

As it turns out, the *Cotton Dust* case was a battle that the proponents of cost-benefit analysis would have done better to avoid. The suit was initially brought, of course, against a Carter administration Labor Department that had no inclination to apply cost-benefit analysis and would do so only under the compulsion that the law required it. After January 20 (the case was argued, ironically enough, on January 21), with a new administration sympathetic to cost-benefit analysis and predisposed to reconsider the cotton-dust standard on that basis, the crucial issue became the quite different question whether the law merely *permitted* it. But in resolving the former, alas, the Court might suggest a negative response to the latter as well. Thus, after the *Cotton Dust* case had already been argued, the new Labor Department took the extraordinary step of requesting the Court to vacate the judgment of the lower court (which had upheld the agency) and send the matter back to OSHA for "further consideration and development." A similar disposition was urged by the corporate petitioners—so that the only parties eager to have the Court proceed with the business at hand were the labor unions who were the government's (at this stage unwelcome) allies.

The Court proceeded anyway, and in the majority opinion the Labor Department's worst fears were realized. Rehnquist's dissent bravely asserts that "as I read the Court's opinion," it "concludes that, at least as to the 'Cotton Dust Standard,' the Act does not require the Secretary to engage in a cost-benefit analysis, which suggests of course, that the Act *permits* the Secretary to undertake such an analysis if he so chooses." With respect, it suggests no such thing—and a fairer characterization of the majority opinion is that the act does not require cost-benefit analysis precisely *because* it forbids it. (The majority opinion expresses its disagreement with Rehnquist's description—with admirable subtlety and economy of style—by stating in a footnote, almost in passing, that "[e]ven had Justice Rehnquist correctly characterized the Court's opinion" the consequences he asserted would not follow.)

One may be thankful that Stewart, who has recently announced his retirement, was not one of the five majority justices in the *Cotton*

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Dust case. We may thus be spared the further prolongation of false hopes that cost-benefit analysis will come to OSHA's toxic material standards. It always was a poor argument—and got only one vote in two cases.

That having been said, it is also appropriate to dash some cold water on the excessive jubilation of regulation-prone commentators who have ballyhooed the case as a major defeat for cost-benefit analysis in general. It is no such thing. It applies only to the distinctive statutory language governing OSHA standards—and, indeed, not even all OSHA standards but only those pertaining to toxic materials or harmful physical agents. In fact, it is something of a *victory* for cost-benefit analysis in general, since even the majority justices were willing to acknowledge that the definitional provision quoted earlier, applicable to all OSHA rulemaking not otherwise constrained, "might be construed to contemplate some balancing of the costs and benefits of a standard."

Moreover, it should not be thought that the Reagan administration has no maneuvering room even with respect to toxic-substance standards. For even though "feasibility" rather than "cost-effectiveness" is the governing criterion, God (as well as Rehnquist) knows there is a good deal of stretch in that concept, and the initial call is for the agency rather than the courts. So under its new direction, OSHA may well revise the cotton-dust standards, *American Petroleum Institute* v. *Donovan* notwithstanding.

If such revision occurs, then—for aficionados of the bullfight of administrative law litigation—one of the most interesting of passes may ensue. The reviewing court (which in future cotton-dust challenges is likely to be the D.C. circuit, as it was in this one) is supposed, according to the Administrative Procedure Act, to give deference to the agency's judgment; but on appeal from the reviewing court, the Supreme Court is supposed, according to its own opinions, to give deference to the *reviewing court*'s judgment, upsetting it "only in what ought to be the rare instance when the standard [of review] appears to have been misapprehended or grossly misapplied." (This passage was pointedly quoted by the majority in the present case.) If this transfer from hand to hand of the cloak of persuasion is skillfully executed, it may well be that the Reagan administration's revised calculation of what is "feasible" by way of cotton-dust standards will be set aside by a moderately (but not grossly) undeferential D.C. circuit, and that erroneous result affirmed by a Supreme Court which is appropriately deferential to such lack of appropriate deference. *Olé!*

Lifting Burdens at the Margin

Unlike deregulation in other areas, financial deregulation has not been the outcome of a deliberate political effort, either by the industry or by outside reformers. Instead it has mostly emerged as an unavoidable consequence of institutional and technological advances (money market funds, electronic funds transfer). These have rendered old regulatory barriers meaningless, eroding the competitive position of some firms and eventually leading to a crisis that has made reform necessary. Now the Federal Reserve Board is thinking of relaxing another set of financial rules that, while having provoked no crisis, no longer appears to address the realities of the marketplace: margin requirements, which specify the portion of a securities purchase that can be financed by borrowing from brokers or other lenders.

When Congress ordered the Federal Reserve to set margin requirements in 1934, memories of the 1929 stock market crash were still fresh. It was believed that the practice of trading on margins as high as 90 percent had fed both the boom and the subsequent bust, first by expanding the pool of capital for stock speculation during the boom, and then by forcing margin traders to sell in falling markets as the decline in the value of their holdings triggered a margin call. Curbs on the credit that lenders could extend to stock buyers would restrain this "pyramiding" process, it was thought, reducing the volatility of stock prices. Paternalistic motives were also at work: margin limits would keep investors from taking on more risk than would be good for them.

Whatever the merit of these arguments at the time, changes in securities markets since then have made the rules look increasingly archaic. To begin with, now the stock exchanges not only set their own margin requirements, but also have "investor suitability" rules to

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In Brief–

Update: Taking a Dive at the CPSC. "The King of France, with forty thousand men/Marched up the hill, and then marched down again." The Federal Trade Commission did something similar in its five-year-long proceeding on over-the-counter drug advertising (see Bruce Yandle, "The Cost of Getting Nowhere at the FTC," p. 43). But pity the poor Consumer Product Safety Commission, which, having paid to march up the hill, now cannot afford to march back down again.

CPSC would like to revoke its 1976 rule on swimming pool slides. An appeals court struck down two major sections of that regulation in the landmark 1978 *Aqua Slide 'n Dive* decision (see Perspectives, *Regulation,* May/June 1978), and the rest of the rule was of little benefit by itself in the commission's view. But getting rid of a rule once adopted was no easy matter, the commission found. It would take two to three years of staff time, probably costing more than $100,000, if (as seemed likely) the revocation was challenged in court. That, said Commissioner Stuart Statler, would "throw good money after bad." So the rule remains on the books.

Who would sue to keep it there? None other than the very Aqua Slide 'n Dive Corp. which challenged the original regulation in court. Aqua Slide 'n Dive had in fact petitioned CPSC to adopt a rule in the first place, and later objected only to the warning label and installation requirements which were struck down by the court. The design features of the rule conformed with Aqua Slide 'n Dive's production molds, says Commissioner David Pittle, and "as a direct consequence . . . the few small competitors, whose molds did not conform, were driven from the field, creating a complete monopoly for the leading manufacturer." The number of known manufacturers of pool slides has fallen from seven to one under the standard.

Fighting the Legacy of Colonialism. Among the most popular figures in Brazilian politics is Hélio Beltrão, who holds the office of "extraordinary minister for debureaucratization." Beltrão has launched a crusade against paperwork that has already wiped out more than 400 million documents once required by the government, and has issued a hundred edicts aimed at cutting red tape in various ways. His efforts seem to have struck a deep chord among ordinary Brazilians, although the magazine *Visão* notes that "some lawyers view his attempts as threats to the market for legal services."

Like many Latin American reformers before him, Beltrão considers the evils he is fighting to be a legacy of the colonial past. "Brazil is a country that was born regulated, since even before it was discovered and settled there were official documents on how it was to be governed," he explains. Among the "vices and habits inherited from the colonial past," he says, are "an exaggerated centralization of decisions" which "deludes itself into trying to impose uniform solutions on an enormous country that is rich in local peculiarities; an adherence to formalism which grants more importance to a document than to a fact; and finally, a morbid presumption of distrust, the trademark of most of the laws, regulations and norms of public administration in Brazil."

It's All Downhill from Here. A resort near Echo Summit, California, has been required to make the rest rooms of its new lodge wheelchair-accessible. The crush of handicapped vacationers is expected to be deterred somewhat by the fact that the resort itself, Sierra Ski Ranch, is accessible only on skis. As far as is known, no thought is yet being given to making the slopes wheelchair-accessible.

screen out investors who cannot afford to risk their money. Thus the Federal Reserve rules may simply be accomplishing coercively (at some additional expense) what would in any event be accomplished voluntarily. Moreover, there is some reason to doubt whether anything of importance is accomplished. The general expansion of credit and property ownership has reduced the effectiveness of margin requirements as a paternalistic protection for the improvident. Investors who wish to purchase stock on borrowed funds can now often borrow elsewhere, using holdings other than stock as collateral. As for securing the stability of the market, those high-risk traders who formerly would have borrowed on margin now can and do achieve the same effect by buying and selling in the new stock options market. The high rollers, in other words, have moved to another table.

Margin trading is a far less important factor in securities markets than it was in the 1920s. Only 4 percent of the total value of the shares on the New York Stock Exchange is held in margin accounts, and only around 10 percent of all NYSE trading is done by margin account customers. (The latter figure is higher than the former because margin investors are highly active traders compared to others.) Some of the decline in margin holdings may possibly be a result of high interest rates, and thus is presumably temporary. To a large extent, though, it reflects the massive entry into the market of institutional investors like insurance companies and pension funds, which do little or no margin borrowing, and the more recent use of

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Drawing by Chas. Addams; © 1980 The New Yorker Magazine, Inc.

"There's no cause for panic, Mrs. Munson, but, frankly, there are certain indicators that cannot be ignored."

options as a substitute for highly leveraged stock transactions.

It should come as no surprise, therefore, that empirical studies have found margin rules to have little or no effect on either the level or the volatility of stock prices. If margin rules are a significant constraint on investors, one would expect stock prices to rise when margin rules were relaxed and fall when they were tightened. Any adjustment should take place immediately, since general knowledge of the change should allow all investors to discount its effects fully. According to studies by J. A. Largay III and R. R. West (1973) and R. C. Grube, O. M. Joy, and D. B. Panton (1979), increases in margin requirements were accompanied by average declines of one-half of 1 percent in stock prices the next day, not a sta-

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tistically significant figure. Decreases in margin requirements were accompanied by stock price increases of just over 1 percent, which is statistically significant but small. (The asymmetry between the two results remains unexplained.)

Similarly, in a study of stock price volatility, R. R. Officer concluded that, if changes in the level of industrial production are allowed for, a change in margin requirements in one year is not accompanied by any increase or decrease in the volatility of stock prices during the next year. One could argue, in response to Officer's finding, that margin regulation might be helpful mostly in episodes of panic or market instability, which might not coincide with the changes in the level of margin requirements that Officer examined.

It is also possible that the relative unimportance of margin trading in today's market is itself due to the restraining influence of the Federal Reserve regulations. The way to test the latter assertion, of course, would be to lift the requirements while holding open the possibility of reimposing them if margin credit began to swell substantially. Although it seems unlikely that the Federal Reserve Board will adopt that course, it might consider lifting the requirements in stages, with each stage announced well in advance in order to give markets plenty of warning. A third course, embodied in a set of proposals prepared by the Federal Reserve Bank of New York and recently put out for comment by the board, is to remove only the most burdensome and least useful parts of the regulations.

While it is not easy to compute the costs that margin requirements impose, there is reason to believe they come to a substantial total—including the costs of administration for all concerned, the costs to government and private parties of enforcement and legal defense, and, last but not least, the costs to investors of circumventing the regulations or of holding less preferred portfolios. A decision by the board to relax the rules would take the federal government one step further in the process of doing away with long-standing financial barriers. It would also be a sign that deregulation in the financial area can advance beyond mere haphazard response to successive crises to include voluntary and uncoerced acts.

Regulation and the 1982 Budget

In the debate over the Reagan administration's 1982 budget, the proposed cuts in funding for regulatory agencies were among the most controversial items. The budget and staff reductions for the Federal Trade Commission, Consumer Product Safety Commission, and similar agencies seemed designed not merely to save money, but to alter the fundamentals of policy. To some Reagan partisans, the 1982 budget was a bold stroke to check overregulation at its source; to some opponents, it was an attempt to subvert the mission Congress intended for the agencies and frustrate the enforcement of the laws.

A look at the actual figures for budget and staffing, however, suggests that both hopes and fears may have been exaggerated. As the table below indicates, the 1982 Reagan budget cuts regulatory funding by only 4 percent in real

GROWTH OF FIFTY-SEVEN REGULATORY AGENCIES
Selected Fiscal Years, 1972–82

Area	1972	1979	1980	1981 (est.)	1982 (Carter budget)	1982 (Reagan budget)
	EXPENDITURES ($ billions)					
SOCIAL REGULATION						
Consumer Safety & Health	$ .9	2.5	2.9	3.0	3.2	3.2
Job Safety & Other Working Conditions	$ .1	.6	.7	.8	.9	.8
Energy & the Environment	$ .5	1.5	1.9	2.2	2.5	2.2
	$1.6	4.6	5.6	6.0	6.6	6.2
ECONOMIC REGULATION						
Finance & Banking	$ .1	.3	.3	.4	.4	.4
Other Industry-Specific	$ .2	.3	.4	.4	.4	.4
General Business	$ .1	.3	.3	.3	.4	.3
	$ .4	.9	1.0	1.1	1.2	1.1
TOTAL	$2.0	5.5	6.6	7.1	7.8	7.4
TOTAL IN 1970 DOLLARS*	$1.8	3.1	3.3	3.3	3.3	3.1
	PERMANENT FULL-TIME POSITIONS (thousands)					
SOCIAL REGULATION	35.7	63.4	64.1	63.2	64.3	61.0
ECONOMIC REGULATION	18.7	24.0	24.1	23.1	24.5	22.7
TOTAL	54.4	87.4	88.2	86.4	88.8	83.7

*Adjusted by GNP deflator (actual and, for 1982, estimated in budget).

Sources: 1972–80 and 1982 Carter budget, Center for the Study of American Business; 1981 and 1982 Reagan budget, preliminary figures compiled by *Regulation*.

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terms, both from estimated 1981 levels and from the Carter administration's planned 1982 levels. It cuts staffing ceilings by 3 percent from estimated 1981 ceilings and by 6 percent from planned Carter administration ceilings.

The summary figures shown here are taken from the annual roundup of regulatory agency budgets and staffs prepared by the Center for the Study of American Business at Washington University in St. Louis, supplemented with preliminary staffing data compiled by this magazine. The figures do not take into account congressional action on the budget.

Among major agencies, the steepest cuts are slated at the Department of Energy's Economic Regulatory Administration, which used to regulate oil prices (a 74 percent cut, from $144 million in fiscal 1981 to $37 million); the Department of the Interior's Office of Surface Mining (28 percent, from $156 million to $113 million); and the CPSC (24 percent, from $42 million to $32 million). These three agencies account for about half of the 4 percent real reduction in overall regulatory spending. Others, like the FTC and the Securities and Exchange Commission, got increases in absolute terms, though not enough to keep up with expected inflation. But some of the agencies most roundly criticized by candidate Reagan before the election emerged with real increases: the Occupational Safety and Health Administration, up 9 percent; the Environmental Protection Agency, up 12 percent; and the National Highway Traffic Safety Administration, up 28 percent.

Another way of looking at the Reagan total for regulatory agencies is chronologically. It rolls back only about two years of real growth in agency budgets, leaving them below 1980 and 1981 levels

CHANGE IN EMPLOYMENT FOR TWENTY-EIGHT REGULATORY AGENCIES

Agency	Permanent Full-Time Positions 1980	1981	1982	Percent Increase (Decrease) 1980–82
Consumer Product Safety Commission	871	812	633	(27)
Food and Drug Administration	7,419	7,365	7,305	(2)
Antitrust Division	939	939	897	(4)
Federal Railroad Administration	484	431	421	(13)
National Highway Traffic Safety Administration	874	751	640	(27)
Bureau of Alcohol, Tobacco, and Firearms	3,900	3,868	3,862	(1)
TOTAL, Consumer Safety & Health	*14,487*	*14,166*	*13,758*	*(5)*
Mine Safety & Health Administration	3,857	3,810	3,808	(1)
Occupational Safety & Health Administration	3,015	2,626	2,536	(16)
Equal Employment Opportunity Commission	3,433	3,416	3,326	(3)
National Labor Relations Board	3,157	2,880	2,990	(5)
TOTAL, Job Safety & Other Working Conditions	*13,462*	*12,732*	*12,660*	*(6)*
Economic Regulatory Administration	2,161	1,772	399	(82)
Office of Surface Mining, Reclamation, and Enforcement	759	941	767	1
Environmental Protection Agency	10,678	10,800	10,400	(3)
Nuclear Regulatory Commission	3,041	3,300	3,325	9
TOTAL, Energy & the Environment	*16,639*	*16,813*	*14,891*	*(11)*
Comptroller of the Currency	3,331	3,153	3,005	(10)
Federal Deposit Insurance Corporation	3,691	3,741	3,791	3
Federal Home Loan Bank Board	1,388	1,435	1,464	5
National Credit Union Administration	650	718	718	10
TOTAL, Finance & Banking	*9,060*	*9,047*	*8,978*	*(1)*
Civil Aeronautics Board	743	650	638	(14)
Commodity Futures Trading Commission	550	470	470	(15)
Federal Communications Commission	2,153	2,004	1,941	(10)
Federal Energy Regulatory Commission	1,605	1,630	1,731	8
Federal Maritime Commission	361	312	301	(17)
Interstate Commerce Commission	1,940	1,730	1,600	(18)
TOTAL, Industry-Specific Regulation	*7,352*	*6,796*	*6,681*	*(9)*
Patent & Trademark Office	2,734	2,834	2,954	8
Federal Election Commission	251	235	227	(10)
Federal Trade Commission	1,665	1,564	1,379	(17)
Securities & Exchange Commission	2,100	1,939	1,850	(12)
TOTAL, General Business	*6,750*	*6,572*	*6,410*	*(5)*
TOTAL, TWENTY-EIGHT AGENCIES	*67,750*	*66,126*	*63,378*	*(6)*

Source: 1980 figures from the Center for the Study of American Business; 1981 figures and preliminary estimates of 1982 figures compiled by *Regulation*.

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but ahead of 1979 and all earlier years. The 1982 budget is about 60 percent higher than that of 1972, and nearly 300 percent higher than that of 1970.

If history is any guide, moreover, the new set of budget figures will rise during the course of the year. The 1980 budget for regulatory agencies was first estimated at $6.0 billion; it eventually amounted to $6.5 billion. The 1981 budget, similarly, rose from a preliminary forecast of $6.9 billion to a current estimate of $7.2 billion. If the 1982 budget experiences similar overruns, real agency spending may end up increasing after all.

Staffing levels showed a similar modest decrease. As with the budget, the sharpest cut came in energy price regulation, which lost 1,300 employees, accounting for half of the total shrinkage in the regulatory work force. Other agencies had an average manpower decline of about 1½ percent—an unprecedented event in recent times, but hardly the Incredible Manning Shrink. The table below lists figures for selected agencies.

It should be kept in mind that agencies sometimes operate below their staffing ceilings. Another factor at work is the desire to replace federal employees with outside contractors. Thus the actual effect of staffing cutbacks may be more or less than the official figures imply.

Stable or increasing budgets do not necessarily mean business as usual among the regulators. The Nuclear Regulatory Commission's budget and staff increases were reportedly intended to speed up regulatory approval procedures, for example, and elsewhere in the bureaucracy resources are being shifted to economic analysis from more traditional functions. It is still not clear whether the administration will eventually change the fundamental approaches of the various regulatory agencies. But whatever its overall substantive policy proves to be, its budgetary policy on regulation appears to be one of thoroughgoing gradualism.

Overseas Ethics, Four Years Later

Economists have thus far paid scant attention to the wave of good-government and ethical regulations enacted in the 1970s. There is, indeed, growing criticism of the Freedom of Information Act, the financial disclosure and conflict-of-interest rules, and so forth; but it comes from politicians and business people who deal with the laws daily, not from regulatory reformers.

One reason may be that it is impossible to gather reliable data on "under-the-table" transactions or the effects of secrecy. Another may be that economic theory is not well-equipped to analyze clandestine goings-on. Whatever the cause, both supporters and opponents of the newer ethics and openness laws have little more than anecdotal evidence on their actual effects, with nothing in the way of a cost-benefit analysis in sight.

The Foreign Corrupt Practices Act of 1977 is an example of both the sweeping economic impact of ethics laws and the difficulty of assessing their unintended effects. The act has a much broader scope than its name implies: in the manner of Voltaire's Holy Roman Empire and Churchill's Lord Privy Seal, its domain includes matters that are neither foreign, nor corrupt, nor practices. (In particular, it regulates the accounting concepts companies must use within the United States, in order to force corporate managements to centralize the control of their far-flung subsidiaries.) And while there is some agreement that the act has succeeded in reducing bribery at the cost of lost sales and high record-keeping burdens for U.S. business, the magnitude of either costs or benefits is largely a matter of guesswork.

At the moment the controversy over the act is in fact mainly a battle of "horror stories." Proponents of the law point to over 300 cases of questionable payments reported by U.S. companies during the years before the act was passed, including scandals that shook the governments of Italy, Belgium, the Netherlands, and Honduras and toppled the Tanaka government in Japan. Critics, including the U.S. Chamber of Commerce, have assembled numerous case histories of how innocent U.S. firms have lost sales and competitive positions overseas because of uncertain or inflexible provisions of the law. A General Accounting Office survey of 250 randomly chosen companies indicates that such dissatisfaction is widespread in the business community.

The major reason is the accounting provisions of the law, which are binding on firms whether or not they do overseas business, and

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which are enforced by sanctions almost as tough as those of the law's anti-bribery provisions. Both carry a maximum penalty of five years in prison. The bribery penalties apply irrespective of whether it was the firm or the foreign official that initiated the suggestion of payment. The act's legislative history does indicate, though, that payments extorted by threats of damage will not be considered bribes, and that "grease payments" (fees to expedite the handling of claims to which a firm is legally entitled) will be allowed. In this and other areas the law has proved ambiguous, however, and the criminal penalties cause executives to shy away from borderline actions.

The "chilling effect" of such ambiguity, along with the act's heavy record-keeping burden, is enough to harm U.S. competitiveness even in world markets where bribery is not prevalent, business spokesmen have alleged. Where bribery is endemic, the law has required U.S. business to withdraw, leaving the field to the Europeans and Japanese. No other country has a law like ours.

The requirement that internal corporate control procedures maintain the accountability of foreign subsidiaries—in other words, that there be a strong centralized chain of command within the corporation—raises another concern. It is commonly observed that, in bureaucracy and red tape, the modern corporation is not that different from the modern government. What is less commonly observed is the role regulation plays in producing such bureaucracy. Federal contract procedures that bar an entire firm from doing business with the government if one of its divisions misbehaves, various rules that hold firms liable for the actions of their employees and even their customers, company-wide hiring quotas—all these encourage centralized and rule-bound management. The Foreign Corrupt Practices Act goes very far in this respect, even making U.S. firms liable for the behavior of overseas joint ventures in which they have only a minority interest. The act also holds management responsible if it had "reason to know" of a subordinate's corrupt act, a stricter standard than applies in the law on *domestic* bribery.

There are only a handful of statutes that control what Americans can do, or allow their agents to do, abroad. Extraterritoriality, as it is called, raises numerous problems such as the risk of double punishment (under the laws of two sovereigns), the difficulty of subpoenaing witnesses, and the impossibility of providing trial in the area where the crime was committed. Previous criminal laws of this type had sought to keep Americans abroad from harming Americans back at home through such practices as ocean dumping beyond the three-mile limit and price-fixing that affected U.S. buyers and sellers. This limited international friction by providing an easily understood rationale for U.S. legislative involvement. The harm to U.S. interests that the Foreign Corrupt Practices Act seeks to prevent is less direct: official embarrassment, a lowered national reputation for honest dealings, and political damage to our allies. As a generalized attempt to keep Americans on their best ethical behavior abroad, however, the act remains an anomaly. It is still not against federal law for an American to rob a bank overseas—but it is illegal to pay off an official to obtain a pushcart license.

There has been only one successful prosecution under the act, of a small firm that distributes the postage stamps of the Cook Islands. This indicates, depending on one's point of view, that the law (a) has cut bribery substantially, (b) has not been earnestly enforced, or (c) has proven inherently unenforceable. There is some evidence for each of these views. The General Accounting Office survey of companies found that the law had "greatly affected" internal corporate codes of conduct, and that 75 percent of the companies surveyed had revamped their internal accounting controls. The agencies that share enforcement of the act have spent more time on the exegesis of its many ambiguities than on prosecuting cases. And it is probable that some bribery has just been driven further underground, never to be discovered.

Enforcement is split between the Securities and Exchange Commission, which enforces the civil provisions of the law on all SEC registrants, and the Justice Department, which covers companies not registered with the SEC and enforces all of the law's criminal penalties, including those for accounting provisions. Both agencies have been criticized by business for inadequate guidance concerning the act's gray areas. The Justice Department has made at least some efforts to offer guidance; the SEC,

(Continues on page 59)

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Viewpoint

Tom Bethell

No Growth–No Vacancies

THERE IS A TENDENCY in Washington to see all economic and regulatory problems as federal in origin, with state and local contributions often relegated to a minor or nonexistent role. And this makes sense, too. In the first place, most people in Washington who concern themselves with public policy issues do not have time to think much about local matters, which therefore tend to dwindle away into molehills compared to the regulatory mountain ranges of the federal establishment —the Clean Air Act, the National Environmental Policy Act, affirmative action, the Occupational Safety and Health Administration, and so on.

In addition, there are good reasons for being more concerned about the problems of regulation at the federal level. Above all, local obstacles to economic activity are easier to overcome, in one important respect, than nationwide obstacles. The former can be circumvented, after all, by U-Haul truck and interstate highway; the latter may well require ocean liner or tramp steamer. When citizens have to emigrate in order to work (as now appears to be the case in Mexico), a nation is indeed in a bad way.

In this respect, then, the fragmentation of government jurisdiction is beneficial, because people always tend to seek out the jurisdiction having the lowest level of taxation and regulation. Local governments thus compete with one another, "bidding" for residents (taxpayers). The lowest bidder, in a sense, sets the marginal price of government, which will then constrain the price of government in all other jurisdictions.

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Put another way, when people start moving in large enough numbers from Brooklyn and the Bronx to Dallas and Houston, then the governing authorities in New York are compelled to start thinking about the costs they are imposing on their (dwindling) band of taxpayers. And probably nothing *will* concentrate the minds of office holders so effectively as vanishing taxpayers.

That is the beneficial aspect of fragmented government. But there is also a bad side. When the geographical scope of government is small, the number of people needed to influence its decisions diminishes accordingly. And so a small but determined band can impose regulations that will prevent almost anything from happening. This, in fact, was one of the most underemphasized stories of the U.S. economy in the 1970s.

When the geographical scope of government is small. . . . a small but determined band can impose regulations that will prevent almost anything from happening.

We can see this problem more clearly if we think of nuclear waste disposal. People do not want nuclear wastes in their neighborhood. So if each neighborhood is vested with the power of government, and the entire country is simply a patchwork quilt of such neighborhoods, there will be prohibitions against waste disposal sites everywhere. But we have to put nuclear waste somewhere. The same problem would not arise if there were only one all-encompassing federal government, because the small number of people who would object to a nuclear waste site in a given spot would not (one may presume)

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have an equivalent degree of influence over a government that represented so many more people.

Explaining Rent Control

Local governments can, therefore, impose severe constraints upon the economic life of the citizenry, as I discovered during a recent visit to California where I was "writer-in-residence" at the Los Angeles *Herald Examiner*. I was forced to stop thinking about President Reagan's economic proposals, the defense budget, and other Washington matters, and start thinking about local and regional affairs. My aim was to try to provide an economic explanation of events, insofar as this was possible. This entails trying to find out *why* things are the way they are, and laying bare the incentive structure that produces a given status quo.

One of the first things I decided to look into was housing prices, a favorite topic of conversation in Los Angeles. "Pretend you are a wealthy visitor wanting to buy a house in Beverly Hills!"—someone recommended to me. "Find out what a million dollars will buy!" In a way, this was typical of an attitude that is common among journalists. I was being encouraged to *exclaim* about the high price of houses, not *explain* them.

I also became interested in the high cost of apartment rents in the greater Los Angeles area. Here, of course, I immediately encountered the familiar story of rent controls. In Los Angeles the city council had enacted a rent control ordinance in 1978. And in Santa Monica—a separately incorporated city fifteen miles or so from downtown L.A.—the voters had adopted by referendum a particularly severe form of rent control in 1979. In addition, Santa Monica would soon have city council elections, with a slate of business-backed moderates running against four candidates (Santa Monicans for Renters' Rights) loosely affiliated with Tom Hayden's Campaign for Economic Democracy, and dedicated to implementing an even greater degree of government control over the local economy.

One day I went to see Charles Isham, the executive vice-president of the Los Angeles–Western Cities Apartment Association. He owns two twelve-unit apartment buildings, one in Los Angeles and one in Santa Monica. Isham told me that the typical apartment owner in the Los Angeles area is the smallest of small businessmen, usually a husband and wife who have sunk their life savings into one apartment building, in one unit of which they also live. Many of these owners are members of black, Oriental, or Hispanic minorities. However, the hostility to property rights of those who agitate for rent control is so great that they are quite unmoved by the racial or ethnic status of the property owners.

Isham seemed to regard the whole problem of rent control as nearly insoluble: politicians, he said, think in the short run (up to the next election), while the adverse effects of rent control only emerge in the long run. But he continued to hope that the California Supreme Court would ultimately uphold the constitutionality of property rights. Meanwhile, he said, the number of apartment units in Santa Monica had dwindled by about 3,000 since the enactment of rent control.

I took this information to Dennis Zane, one of the Renters' Rights candidates for the Santa Monica city council election. He told me that I had cause and effect the wrong way around. The number of apartment units began to decline before rent control came in. And that, he argued, is why there is rent control: as rents for the diminishing apartment supply rose, so did the pressures to do something about it politically.

In response to this point, Isham said something that really *explained* rent control. He attributed it to the no-growth laws that had been passed in L.A. and Santa Monica (and in many other California cities) several years earlier.

"My twelve-unit building in Santa Monica was constructed in 1965," Isham said. "If I were building it today I could not have more than six units, because now you can only build on 50 percent of the lot. It used to be about 80 percent. Consider someone who has a parcel of land. The clock is running on his mortgage costs. He is only allowed to build six units. And he also has to provide underground parking and other features—perhaps elevators—which make the units more expensive to build and maintain. To recover the builder's costs, rents might have to be as high as $2,000 per month. People can't afford to pay that. But they will buy condominiums, because of the tax break and the equity buildup." In other words,

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changes in the law created incentives for condos and disincentives for apartments.

The result was that apartment construction fell off immediately, and rental prices on the dwindling stock of apartment units were promptly bid up by a continuing wave of new arrivals. To arrest this price rise, rent controls were enacted, and at that point no further apartment construction was undertaken at all. (See Readings, page 55.)

The foregoing applies to Los Angeles as well as Santa Monica (with local differences in the details of the no-growth laws). The rental market in L.A. is in much better shape, however, because the rent control law there includes the important feature of "vacancy decontrol." Thus prices are ultimately set at the margin and it is not necessary to "queue up" for a vacancy. New renters merely pay higher and higher prices, because there is no new supply. Indeed, checking at city hall, I could not find *even one* privately financed apartment building under construction in L.A. today. One wonders what the city will be like as a place to live in ten years hence. Probably more and more like New York today. There will be a lot of nice places for rich people, but nothing for poor people who are just arriving and trying to make their way.

And when you come to think of it, it is in just this spirit that the no-growth laws were enacted in the first place. No-growth laws are used by the "ins" to fend off the "outs." People who live in a neighborhood or city and find it pleasant, except to the extent that newcomers create overcrowding and spoil the view, are inclined to pull up the drawbridge by enacting no-growth laws. In the long run, however, such laws will undermine a local economy. An economy can be regarded as a pyramid, or ladder, and a ladder without lower rungs is useless. It is the same with cities: making life difficult for working-class newcomers will eventually ravage the entire economy.

Fixing One Bad Scheme with Another

In Santa Monica the situation is far worse because the rent control law permits only small annual rent increases—computed as a percentage of the purchase price (which of course could have been relatively tiny in the 1960s). Thus rents are far below market value. In such a situation you get a large number of applicants for each apartment vacancy. Who decides who gets these vacancies? The owner, for now, but Isham reported there were plans to set up a new scheme, a "selection committee" that would allow the politicians in city hall to decide who would be favored with inexpensive places to live. And of course they would be strongly inclined to favor their friends—the very people who organized on behalf of rent control in the first place (with the help of money from the Law Enforcement Assistance Administration and Comprehensive Employment Training Act, as it turned out).

By the way, the pro-rent control radicals—Santa Monicans for Renters' Rights—won all four seats in the city council election, and their first move was to impose a six-month moratorium on most new construction in the city. This of course was largely superfluous, because developers were already running away from Santa Monica as fast as they could—to places like Houston and Dallas, where they have a better chance of achieving a rate of return on their investments higher than the going interest rate.

Rent control is a disaster—as almost everyone except the dedicated socialist knows by now. But the truth is that, even if all rent control laws in the L.A. area were abolished, apartment construction would still not resume. The no-growth laws would also have to go.

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Another regulatory scheme that has emerged at the local level in the wake of the rental housing shortage is "inclusionary zoning." This has already been implemented in Orange County and in areas of Los Angeles controlled by the California Coastal Commission. And it will shortly appear in Santa Monica in more extreme form. "Inclusionary zoning" means withholding construction permits until the developer agrees to rent or sell a certain percentage (15 percent in Orange County) of condo units in the new building to low-income

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buyers at a fraction of the market price. As Isham pointed out, this is likely to lead to considerable social tension. Living next door to one another in identical units there will be one family paying $1,000 a month and another family paying a fraction of that. Moreover, the criteria whereby the low-income families are admitted might by the same token bring welfare and its attendant crimes and disorders into buildings partially occupied by middle-class families paying the full price (in more senses than one). A recent case in Orange County illustrates further difficulties. Units selling for about $150,000 were apportioned to selected applicants for as little as $25,000. (And the housing authorities, not the owners, made the selections.) But those with incomes low enough to qualify for the "inclusionary" units had incomes *too* low to qualify for mortgages. Moreover, the local assessor insisted on valuing the units at true market value, resulting in equally unaffordable property taxes. So the selected beneficiaries still could not afford the units, which stand empty. In response, the politicians are now demanding that the units be "sold" for an even lower price.

Growing Elitism

What about the housing market in Los Angeles? First of all, the average price of a new house in L.A. is about a third higher than the national average. Furthermore, whereas fully 46 percent of California's residents could afford to buy a median priced home in 1976, that figure is down to 7 percent today. Of course, interest rates are largely to blame for the latter statistic. But when we look at the house price itself, we find that local ordinances once again must bear a large portion of the blame. What happened in California was that cities, including L.A., adopted regulations increasing the permissible lot size. In this way, of course, the "era of limits" that we heard so much about in the early 1970s became a kind of self-fulfilling prophecy.

An official in L.A.'s Department of Building and Safety explained it to me this way: "Ten years ago a builder could easily get a subdivision zoned R-1, which allowed you to build a house every 5,000 square feet. Now the city planning department is looking at 10,000 or even 15,000 square feet. Instead of granting R-1 zoning, it insists on 'residential estate zoning,' which usually doubles the amount of space required per house."

In L.A. you often hear it said that "we are running out of space." Less often do you hear it said that local governments have *decreed* this outcome by requiring that each new house occupy *more* space. And what has been the effect? Typically land costs account for about a third of the final house price. Is it surprising that, when the size of the lot is doubled, houses cost one-third more than the national average?

This is a product of elitism pure and simple. Requiring larger lots makes life harder for newcomers and the poor, by making it impossible to build inexpensive houses. In support of this view, an August 1980 report from the housing director of L.A.'s Community Development Department sounded the theme of "growing elitism." Noting that the public has been demanding regulation as a means of preserving the environment, it explained that "this is often just a rationalization or facade for an attitude that says: 'I have mine and I really don't want anyone else in my community.' " This attitude, as the report went on to point out, has also been reflected in delays and rejections of construction permits, brought about by "environmental and no-growth obstructionism" in the form of endless appeals, injunctions, moratoriums, and study sessions. "Only a few years ago developers could expect to process a piece of raw land into a building project within 90 days with virtually no risk of failure. Today that 90 days may take two or three years, with failure and major project modifications occurring one-third of the time, and density reductions now a part of every subdivision approval."

Requiring larger lots makes life harder for newcomers and the poor, by making it impossible to build inexpensive houses.

I USED TO TRY to make some of these points to journalists—by way of explaining why housing prices were so high. Many of the journalists were interested, because they, too, wished they could afford to buy a house. But do you know what they would say to me? "Tom," I heard them say more than once, "what you are giving us is the businessman's point of view." ■

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Sierra Club v. Costle

Regulatory Oversight Wins in Court

Michael Sohn and Robert Litan

While the Supreme Court's decision in *Cotton Dust* has dominated recent regulatory news, a lower court's decision in *Sierra Club* v. *Costle,* issued several weeks earlier, is likely to have a far larger impact on executive branch and congressional efforts to reform the regulatory process.

Sierra Club involved the Environmental Protection Agency's "scrubber" regulation, which requires that coal- or oil-fired electric utilities install controls to reduce emissions by the same percentage, with little regard to the "cleanness" or "dirtiness" of the fuels being used. The court upheld the substance of that regulation and, at the same time, resolved procedural questions of equal, if not greater, importance. EPA's scrubber rule was issued in July 1979, after more than two years of study and consultation involving not only the agency, but also officials from the Department of Energy, the Department of Interior, and the White House. There were also consultations, after the comment period had closed, between EPA and various interest group representatives, as well as then-majority leader Senator Robert Byrd (Democrat, West Virginia) and the President himself. In a thoughtful and articulate opinion by Judge Patricia Wald, the U.S. Court of Appeals for the District of Columbia Circuit addressed the Sierra Club's challenge to the legitimacy of those post–comment period meetings. Not only did it reject that challenge, but it gave a ringing endorsement to the efforts of the President and his advisers to monitor and provide input to the decisions made by the "single mission" regulatory agencies.

Because of the issues involved and the thorough treatment given them by the court, *Sierra Club* v. *Costle* has important implications for the regulatory oversight procedures recently established by the Reagan administration. The opinion provides timely judicial support for the concept of Office of Management and Budget (OMB) oversight of executive branch regulatory agencies under Executive Order 12291. It also contains observations about the informal rulemaking process in general that deserve to be explored by all those interested in how regulations are developed.

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The Issues: Who Should Pay to "Clean" the Air?

In the long history of the rulemaking at issue in *Sierra Club* and of the statute that it implemented, a classic question recurs: who shall pay to clean the air?

The national commitment to the goal of clean air was made in 1970 when Congress amended the Clean Air Act to require that EPA set national ambient air quality standards for major pollutants to "protect the public health," and that the states enforce the standards by setting limitations on emissions. However, while mandating the goal of clean air—which was to be attained regardless of costs—Congress also displayed sensitivity to the distributional question of who would bear those costs. The members recognized that national health-based standards could have major effects in limiting economic growth in states where ambient air quality was poor. They recognized, too, that the system would permit states having relatively cleaner air to attract industry from other states by setting less stringent emission limits.

To mitigate these distributional concerns, Congress included in the 1970 amendments a requirement that EPA set uniform performance standards for all major *new* sources of emissions across the country, but left the politically tougher problem of emissions from *existing* sources to the states. The standards were to reflect what the best system of adequately demonstrated technology could achieve. In December 1971, EPA implemented these instructions by issuing its new source performance standard (NSPS) for large fossil-fired electricity generating plants, a major source of sulfur dioxide (SO_2) emissions. The standard limited SO_2 emissions from these plants to 1.2 pounds per million British thermal units (MBtus) of heat content of the fuel. This 1971 standard—which Congress required of EPA in order to solve one set of distributional concerns—soon created an entirely different distributional problem.

The predominant fossil fuel used in generating plants was then, and still is, coal. And, in general, coal from the eastern states (notably West Virginia) and many midwestern states as well, has a much higher sulfur content, and therefore produces greater amounts of SO_2, than coal mined in the West. At the time, two technologies were available for controlling SO_2 emissions from coal-fired plants: physical "washing" of the coal before it is burned and the more expensive process of flue-gas desulfurization ("scrubbing"), an embryonic system for removing sulfur from the gas emitted as the coal is burned. It did not take utility managements long, however, to discover a third and simpler way. Because the 1971 NSPS was a standard of performance, measured in terms of SO_2 emissions from a smokestack, it could be met simply by burning low-sulfur western coal, thus avoiding the cost of installing pollution control technology. This, of course, created a new interstate rivalry, with the eastern coal states (primarily West Virginia) complaining that they were losing coal-related sales and jobs to the West.

Congress addressed this new distributional problem in the 1977 amendments to the Clean Air Act by instructing EPA to supplement its emissions ceiling for power plants with a percentage reduction requirement. The exact numerical percentage was left for EPA to fill in; but, as "guidance," Congress directed that it be based on the

> best technological system of continued emission reduction which (*taking into consideration the cost of achieving such emission reduction, and any nonair quality health and environmental impact and energy requirements*) the Administrator determines has been adequately demonstrated [section 111(a), emphasis added].

This provision was the product of an alliance between eastern coal supporters, who argued that their states should not bear the primary burden for "paying for clean air," and environmental groups, who wanted low-sulfur coal to be "scrubbed" to provide cleaner air even where the use of that coal brought emissions below the 1971 performance standard. In any event, the distributional issue was not yet fully resolved since the amendments directed EPA to fill in the exact percentage, taking cost and other factors into account.

The agency addressed these matters in a proposal issued in September 1978. That proposal retained the 1971 ceiling of 1.2 lb./MBtu SO_2, but added a requirement that 85 percent of the potential uncontrolled sulfur emissions from coal (measured over twenty-four hours) would have to be removed. (This requirement

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would not apply, however, if SO_2 emissions were below 0.2 lb./MBtu.) Also, in response to pressure primarily from Department of Energy officials and White House economists—who were concerned that a uniform across-the-board percentage (or "full scrubbing") requirement would not be cost-effective—EPA's proposal asked for comment on "sliding scale" alternatives. Under a sliding scale, the percentage of uncontrolled sulfur that would have to be removed would decline with the sulfur content of the coal used.

EPA's proposal generated enormous interest—reflected in roughly 1,400 public comments, 50 agency meetings and substantive telephone conversations with the public, and 120 studies submitted to the public docket. The proposal also was important enough to merit a lengthy economic analysis from the Regulatory Analysis Review Group (RARG), President Carter's interagency group that watched over executive branch regulatory activities. RARG's primary concern was that by focusing on the *means* for reducing emissions rather than on the *level* of emissions, EPA's full scrubbing requirement would impose unnecessary costs on utilities without achieving corresponding environmental benefits. Ironically, RARG pointed out, the proposed rule would exacerbate the SO_2 problem in some areas, because the expense of installing scrubbers in new generating plants would discourage utilities from replacing their older and "dirtier" plants with newer and "cleaner" plants.

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RARG's analysis, as well as the comments and advice that came from other quarters, was greatly facilitated by EPA's use of a relatively sophisticated economic model capable of projecting under a wide range of assumptions the economic, energy, and emissions impacts (nationally and regionally) of alternative regulatory approaches through the year 1995. The model was also put to great use by a variety of groups after the public comment period closed on January 15, 1979. Over the next weeks, EPA officials discussed their findings with officials of other executive branch agencies and the White House. The pace of such meetings picked up in the spring. On April 5, EPA officials met with representatives from the National Coal Association (NCA), the Environmental Defense Fund, and others to discuss NCA's claim that large coal reserves, mainly in the East, could be rendered valueless if EPA decided to lower the emissions ceiling in addition to requiring a percentage reduction. On April 23, EPA Administrator Douglas Costle met with NCA representatives, Senator Byrd, and presidential adviser Stuart Eizenstat. Six days later President Carter and his advisers met with EPA officials. Finally, on May 2, EPA officials met again with Senator Byrd and representatives of the NCA. Summaries of all these meetings —except the one with the President—and of other staff-level briefings that occurred during the same period were placed in EPA's rulemaking record.

The final rule, published in the *Federal Register* on June 11, 1979, retreated from full scrubbing—but just barely. Specifically, it adopted a percentage reduction requirement for SO_2 of 90 percent averaged over a thirty-day period (equal to the proposed 85 percent averaged over twenty-four hours) if emissions remain above 0.6 lb./MBtu, and of 70 percent if emissions fall below 0.6 lb./MBtu. The 70 percent figure for lower-sulfur coals was settled on late in the rulemaking to encourage the development and use of "dry scrubbing"—a cheaper approach than "wet scrubbing," but one that had not yet been able to achieve 90 percent removal.

EPA's decision was challenged from all sides. Environmental groups claimed, among other things, that the agency had unlawfully abandoned full scrubbing and that EPA's extensive contacts with outside parties, other government officials, and legislators and their staffs ("ex parte contacts") were unlawful. A number of electric utilities challenged the 90 percent removal requirement as too stringent. Other utilities and the National Coal Association also intervened to support different parts of the rule.

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The Court Decision

The D.C. circuit court upheld EPA's final rule in a 253-page opinion issued on April 29. The court's substantive holdings involved both legal and factual issues. First, the opinion construed section 111(a) broadly as permitting EPA to issue a variable percentage reduction requirement. The Sierra Club had argued that the section's legislative history required EPA to set a uniform reduction requirement for all types of coal. The court rejected that argument, relying heavily on statutory language that expressly directed EPA to take such factors as cost and energy requirements into account in setting the standard.

Second, the opinion rejected the Sierra Club's contention that, primarily because of the unreliability of EPA's model, the variable percentage requirement was unsupported by evidence in the record. Although the court recognized that the model was "at best imperfect and subject to manipulation," it refused to agree that, *as a matter of law,* EPA had erred in relying on it to make projections as far as fifteen years into the future. Indeed, the court observed that "computer modeling is a useful and often essential tool for performing the Herculean labors Congress imposed on the EPA in the Clean Air Act." In reaching this conclusion it emphasized that EPA had invited the public to comment on the model and its underlying assumptions, had involved other government agencies and White House economists in the modeling effort, and had admitted the model's limitations:

> The safety valves in the use of such sophisticated methodology are the requirement of public exposure of the assumptions and data incorporated into the analysis and the acceptance and consideration of public comments, the admission of uncertainties where they exist, and the insistence that ultimate responsibility for the policy decision remains with the agency rather than the computer.

Third, the court examined utility industry claims that the 90 percent reduction requirement was not adequately substantiated. In a remarkably detailed thirty-page discussion, Judge Wald waded through a series of statistical and technological arguments and counterarguments concerning the peak performance and reliability of scrubbing systems (by themselves or together with coal washing) before ultimately rejecting the industry contention that the 90 percent standard could not be met.

The procedural challenges to EPA's final rule fared even worse. The court rejected the claims that meetings between EPA decision makers and other government officials following the close of the public comment period were legally impermissible or that a notation of such meetings must always be placed in the rulemaking docket. It left for another day the question whether a rulemaking would be subject to judicial reversal when executive branch officials outside an agency serve as "conduits" for conveying the "off-the-record" views of private parties to agency decision makers, stating that the record did not support the claim that unrecorded conduit communications had occurred.

The court rejected the claims that meetings between EPA decision makers and other officials [were] impermissible. . . .

Implications for Executive Order 12291

The *Sierra Club* decision has obvious application to President Reagan's effort to centralize control over executive branch regulatory activities. The centerpiece of this effort, Executive Order 12291 of February 1981, grants OMB unprecedented powers over the development of new agency regulations. Most significantly, the order gives OMB the authority to "pre-clear" both major regulatory proposals and final decisions. It also upgrades President Carter's "regulatory analysis" provisions to a formal cost-benefit requirement—that is, agencies must demonstrate, to the extent permitted by law, that the potential benefits of their proposals outweigh the potential costs.

To some extent, the Reagan executive order can be viewed as institutionalizing, for *every* major executive branch rulemaking, the procedure actually followed in EPA's rulemaking on new source performance standards. Thus, just as White House economists and other executive branch officials met with EPA

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officials before, during, and after the public comment period to discuss the issues present in the scrubber rulemaking, the Reagan order contemplates the involvement of OMB economists at all of these stages—but on a *routine* rather than ad hoc basis.

There are, however, important differences between the scrubber proceeding and the new Reagan procedures. In the former, EPA voluntarily received advice from officials outside the agency; the new executive order mandates that EPA receive such advice and empowers OMB to hold up the issuance of regulatory proposals and final decisions until the consultation process has been completed. Moreover, it is not yet clear how the Reagan administration plans to deal with the "conduit" problem, on which the court did not rule in its scrubber decision. And finally, the executive order imposes upon the agencies a cost-benefit analysis obligation that was not at issue in *Sierra Club*.

Morton Rosenberg of the Library of Congress recently cited these differences, among others, as reasons to be concerned that the new executive order is legally vulnerable. In a lengthy and well-documented report, he argues that the concentration of such power within OMB *may* displace "the discretionary authority of agency decisionmakers." In addition, he points out that the institutionalization of a review process in OMB heightens the risk that personnel from outside the agency could become "conduits" for off-the-record information, thereby depriving outside parties of their right to respond and hindering judicial review of agency decisions.

While not precisely addressing these issues, the *Sierra Club* opinion sheds some light on all of them:

(1) White House Oversight. The decision's clearest message concerns the role of executive branch officials outside the rulemaking agency in the rulemaking process. The court found such involvement to be legally permissible and in fact conducive to sounder policy judgments:

> The authority of the President to control and supervise executive policymaking is derived from the Constitution; the desirability of such control is demonstrable from the practical realities of administrative rulemaking. Regulations such as those involved here demand a careful weighing of cost, environmental, and energy considerations. They also have implications for national economic policy. *Our form of government simply could not function effectively or rationally if key executive policymakers were isolated from each other and from the Chief Executive. Single mission agencies do not always have the answers to complex regulatory problems. An overworked administrator exposed on a 24-hour basis to a dedicated but zealous staff needs to know the arguments and ideas of policymakers in other agencies as well as in the White House* [emphasis added].

Implicitly recognizing the essentially legislative or "policymaking" character of the informal rulemaking proceeding that was before her, Judge Wald concluded that, in the absence of a congressional direction to the contrary, courts should not erect barriers to frank input at the decision-making stage from all parties in the executive branch who may have something to contribute.

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The scrubber rulemaking is a clear example of how informal rulemakings are suffused with issues of an intensely political character. The battle lines on the scrubber issue were drawn in Congress, first, between high-growth and low-growth states and, later, between eastern and western coal-producing states. The 1977 amendments passed the latter controversy on to EPA to resolve. Once there, the computers whirred and the analysts analyzed, but in the end the most important question the agency had to decide was political: who should foot the bill for cleaner air—consumers or stockholders, in the East or in the West—and how large should that bill be?

The D.C. circuit court properly recognizes an important distinction between formal rulemakings and adjudications on the one hand and informal rulemakings on the other. Whereas the former typically involve highly particu-

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larized issues and a limited number of private parties, the latter typically present broad policy issues involving many individuals and groups, are highly "political" in nature, and require the agency decision maker not only to reach findings of fact, but also to choose among competing interest groups and values. Thus the informal rulemaking is seen as representing a delegation of an essentially legislative function—"filling in the blanks" left in a statute because Congress either did not have time to do so or chose to pass the issue to the agency in order not to risk a consensus in favor of legislation. It is this view of informal rulemaking that prompted the court to adopt a political or legislative, rather than a judicial, model for judging the propriety of agency informal rulemaking procedures:

> Under our system of government, the very legitimacy of general policymaking performed by unelected administrators depends in no small part upon the openness, accessibility, and amenability of these officials to the needs and ideas of the public from whom their ultimate authority derives, and upon whom their commands must fall. As judges we are insulated from these pressures because of the nature of the judicial process in which we participate; but we must refrain from the easy temptation to look askance at all face-to-face lobbying efforts, regardless of the forum in which they occur, merely because we see them as inappropriate in the judicial context.

Having decided that the agency decision maker should not be isolated from others in the executive branch as he or she struggles to reach a sound policy conclusion, the court then all but closed the door to a judicially imposed requirement that the substance of these intragovernmental "policy sessions" be disclosed. While the undocketed meeting primarily at issue in *Sierra Club* involved a presidential meeting, the broad language of the opinion would certainly appear to cover all White House contacts with executive branch agencies. Thus, so long as agencies do not attempt to base their decisions on off-the-record information derived during such meetings, the courts can perform their reviewing function and, in the court's words, do not need to "know the details of every White House contact," including a presidential one. The courts will ascertain whether the agency decision has the requisite factual support in the record, but will not impose requirements designed to preclude the possibility that "undisclosed Presidential prodding" led to a result that is factually based on the record, but different from what the agency head would otherwise have chosen. As the court states, "we do not believe that Congress intended that the courts convert informal rulemakings into a rarefied technocratic process, unaffected by political considerations or the presence of Presidential power."

What, then, of the distinction between Executive Order 12291 and the EPA process approved in *Sierra Club*—the fact the order mandates extra-agency consultation and authorizes OMB to delay issuance of a rule until the process has been completed? It seems to us doubtful that the D.C. court would consider this a distinction with a difference. When it approved "the presence of a Presidential power," surely it was not so naive as to imply that this presence was to be felt only when the agency itself so desired. Similarly, when it decried the "isolation" of "single-mission agencies" that a nonconsultation rule would produce, it could not have meant to imply that self-imposed isolation would be satisfactory. In short, it seems most likely that the court would view the executive order's requirement of extra-agency consultation, and its adoption of procedures to ensure it, to be within the President's powers of managing the administration of the government.

When [the court] approved "the presence of a Presidential power," surely it was not so naive as to imply that this presence was to be felt only when the agency itself so desired.

Of course, *Sierra Club* did not address a situation where the President, or an OMB director acting pursuant to an executive order, *instructs* an executive branch agency to reach a decision that it would not otherwise have taken, especially where, as in the typical regulatory statute, the agency is vested with the decision-

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making authority by Congress. Such a case would test the outer reaches of the President's powers under Article II to "see that the laws are faithfully executed." Yet as a practical matter, such cases may never arise. An agency head is unlikely to risk presidential displeasure by openly bucking a "strongly expressed presidential preference"—or even one from OMB, provided it is supported by the President. Moreover, the judicial reticence to explore the contents of intra-executive branch deliberations exhibited in *Sierra Club* makes it unlikely that the "hard cases" will ever see the light of day.

(2) The "Conduit" Problem. In contrast to its forthrightness in resolving many uncertainties about the legal status of contacts between White House and agency officials, *Sierra Club* refers to, but then skirts, the important "conduit" problem. In particular, the opinion contains themes from two opposing views of informal rulemaking, views drawn from the legislative and judicial contexts, respectively, that leave some doubt as to how the conduit problem will eventually be resolved. Thus, the court notes that while informal rulemaking has an essentially legislative or policy-making character which may justify or even require the accessibility of agency decision makers, we should not lose sight of the fact that it is *not* legislation pure and simple and that lines must be drawn which do not apply when Congress itself is at work.

Informal rulemaking is a method by which Congress delegates the task of solving complex and often technical problems to "experts" rather than deciding them itself. Even in informal rulemaking, Congress has somewhat formalized the methods by which the expert decision maker acquires information, by requiring agencies to provide notice of proposed rulemakings and opportunities for the public to comment on the proposals. Increasingly, in fact, Congress has required the use of additional fact-gathering procedures, including oral hearings, rebuttals, and limited cross-examination. Both the Administrative Procedure Act and these so-called hybrid procedures are designed to ensure that affected persons have a reasonable and fair opportunity to participate in the process and that courts have an adequate basis for reviewing the agency's faithfulness to its statutory mandate. Those related notions—the right to participate and the need for an adequate record—have implications that are foreign to a purely "legislative" or "political" model of rulemaking. For example, if one were to judge informal rulemaking procedures solely by legislative norms, there would not be the concern, expressed recently by the Administrative Conference of the United States, that agencies avoid

> *any possibility* that intragovernmental communications from outside the rulemaking agency might serve as undisclosed or inadvertent conduits for new material factual information, and with providing adequate opportunities for other participants to respond to material factual information that is introduced [ACUS Preamble to Recommendation 80-6].

On June 13, 1981, OMB Director David Stockman sent a memo to executive branch agency heads stating that OMB's procedures "will be consistent with the holding and policies discussed in *Sierra Club*," and that where OMB "receives or develops" factual material that it believes should be considered by a rulemaking agency, it will identify such material as appropriate for inclusion in the rulemaking record. These instructions are far from crystal clear, however. It may often be difficult to distinguish between factual and policy communications from outsiders. Moreover, it is not certain that this new practice applies to oral as well as written communications.

Administration officials would do well to note Judge Wald's reference to the advice that the Department of Justice gave to officials of the Council of Economic Advisers (CEA) during the Department of Interior's strip-mining rulemaking: "summarize and place in rulemaking records a compilation of *all* written and oral comments they receive relevant to particular proceedings" (emphasis added). Indeed, it was largely because CEA and Interior followed this advice that the D.C. district court rebuffed a procedural challenge to the strip-mining rules in 1979 (*In re Permanent Surface Mining Regulation Litigation*). In an article relied on heavily by the *Sierra Club* court, Dean Paul Verkuil of Tulane Law School suggested that the courts should adopt the Justice Department's recommendations to CEA (*Columbia Law Review*, June 1980). The court did not need to address

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this question on the facts before it, because there was no reason to believe that the recommendation had not been followed in the scrubber proceeding or that unrecorded conduit communications had even taken place.

The ambiguities in OMB's June 13 memorandum concerning the definition of factual information and the coverage of oral conversations clearly increase the risk that, in the future, a court will be faced with a case in which unrecorded conduit communications did occur and no policy was in place to record them. From a purely legal perspective, OMB could avoid this risk by automatically passing on to the agency *any* written materials it receives and by logging and docketing all conversations with outside parties. Beyond the legal issue posed by the conduit problem, administration officials might be well advised, as a political matter, to do their own "cost-benefit analysis" in this sensitive area. They might find that the political benefits in terms of perceived fairness of the decision-making process outweigh the administrative costs of dictating and docketing summaries of meetings with nongovernmental officials on subjects of announced rulemakings.

(3) Cost-Benefit Analysis. The third major feature of the executive order that was not part of the process approved by the court in *Sierra Club* is the requirement that agencies conduct "regulatory impact analyses" identifying costs, benefits, and alternatives to their proposals. These analyses in effect form the agenda for consultation with OMB—and OMB has authority to require an agency to extend or supplement its analysis.

In *Sierra Club*, EPA conducted its own regulatory impact analysis; but the fact is that it was not instructed by the President or by OMB as to whether and how to do so. The issue presented by the executive order is whether the President has the power to direct, not the agency's decision, but the manner in which that decision is to be considered.

The answer, of course, is surely not, if that manner includes consideration of factors which the applicable statute forbids, or the ignoring of factors which the applicable statute requires. But the executive order takes account of this limitation by specifying that its requirements do not apply where statutes provide otherwise. The question, therefore, comes down to this: where the agency's statute neither explicitly requires nor explicitly forbids cost-benefit analysis, can the President require it? *Sierra Club* does not address this issue, but the answer would appear to be yes. The cost-benefit requirements of the new executive order do not mandate any particular result. Rather, they specify an analytical *process* to be employed in making regulatory decisions. And, as long as cost-benefit analysis is not precluded by applicable statute, mandating that process would appear to be well within the President's Article II power to supervise and guide his appointees in the execution of laws adopted by Congress.

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Effects of Pending Legislation

The *Sierra Club* case is certain to be of continuing importance for implementation of the President's regulatory reform program, whether or not pending regulatory reform bills are adopted. In their present form, the two principal proposals (S. 1080 and H.R. 746) would solve two of the three problems unaddressed by *Sierra Club*: they would specifically require cost-benefit analysis by law, and they would give the President (or OMB) a role in overseeing the manner in which it is conducted. They leave unaddressed, however, the third uncertainty—the problem of conduit contacts.

Finally, and most important, the bills also leave unaddressed the basic and most significant issue raised in *Sierra Club*: whether the President and his designees are permitted to have some influence not merely upon the process, but upon the very substance of agency decisions. In this regard, the *Sierra Club* case remains an important victory for advocates of a stronger presidential role in the rulemaking process—but only in one battle, and in a war that is sure to continue. ■

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Back to Basics: Making Law without Making Rules

Antonin Scalia

THE 1970s HAVE BEEN aptly described by expert observers of the federal administrative process as the "era of rulemaking." To an astounding degree, a system which previously had established law and policy through case-by-case adjudication involving individual parties—whether in licensing, ratemaking, or enforcement proceedings—began setting forth its general prescriptions in rules, leaving little to be decided in subsequent adjudications beyond the factual issue of compliance or noncompliance with the rules. In the 1950s, for example, one would have expected the Federal Trade Commission (FTC) to make the determination that a particular category of trade practice was "unfair or deceptive" in the course of a cease-and-desist proceeding against a business employing the practice. That case would establish the "rule" (speaking loosely) that the practice was unlawful. Today agency pronouncement of major new prohibitions in that fashion would be unusual. The oft-noted swelling of the *Federal Register* in recent years has been attributable in part, no doubt, to an increased level of federal agency activity; but it has also been caused by an altered *mode* of activity—since rules (in the technical sense), unlike case adjudications, need to be published.

The change from adjudication to rulemaking as the principal vehicle for the establishment of agency policy has been achieved partly through the agencies' use of previously latent rulemaking authority, helped along by the courts' increasing willingness to discern the existence of such authority with respect to issues that could have been held to require adjudicatory treatment. It has also been achieved through congressional conferral of new rulemaking authority upon both old agencies and newly created ones. FTC Magnuson-Moss rules, Occupational Safety and Health Administration standards, and Consumer Product Safety Commission (CPSC) rules are examples.

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Rulemaking's Advantages

Rulemaking was seen to have a number of advantages. When prescriptions were changed by rule, the change was only prospective, so that affected persons had an opportunity to conform their conduct to the government's known desires; agency adjudication, by contrast (like the courts' making of "new law" under their common-law powers), held the citizen accountable for failure to observe a requirement that was not clearly known when he acted. The procedures applicable to rulemaking gave everyone an opportunity to participate; with adjudication, prescriptions governing A could be established in a suit between B (or agency B) and C, in which A had no right to be heard. Moreover, the substance of the prescriptions established by rulemaking was set forth in the *Federal Register* and (if of general and continuing applicability) in the *Code of Federal*

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Regulations, whereas the totality of prescriptions established by adjudication had to be gleaned from hundreds of decided cases.

Rulemaking was also thought to foster better government. It enabled an agency to set its own policy-making agenda, addressing particular issues when it wished instead of waiting for them to be presented in the course of its case-by-case licensing, or ratemaking, or enforcement business. And it could decide a number of related policy issues together, instead of in the piecemeal fashion that adjudication tends to produce. But undoubtedly the greatest attraction for the agencies themselves was the fact that the procedures applicable to rulemaking under the Administrative Procedure Act (APA) were infinitely less demanding (public notice and receipt of written comment, instead of the court-like procedures, including cross-examination, applicable to most significant adjudication); and the requirements for passing judicial review were much less restrictive (the "arbitrary and capricious" standard, instead of the "substantial evidence" requirement applicable to adjudication).

The Advantages Reconsidered

Some of these advantages have been found to have their darker side: If the prospective nature of rulemaking renders agency action fairer, it also encourages expansive interpretation of statutory commands. The public might protest, and the courts balk at, the determination that a long-standing and generally accepted business practice has always been "unfair or deceptive" under the Federal Trade Commission Act, so that persons employing the practice are subject to the liabilities or at least the obloquy that violation of the law entails. The case seems different, however (though the same solipsistic assessment of unfairness and deception is involved), when the agency merely says the practice will be unlawful in the future. The ability of everyone to participate means that organizations with substantial public constituencies (such as the Sierra Club or the Chamber of Commerce) can more readily and directly inject political calculations into even those agency decisions that should be made on a technical basis. And if rulemaking helps the agency to set its own agenda and permits joint consideration of related issues, by the same token it fosters decision making in the abstract, outside the context of a concrete, detailed situation that may serve to clarify both the facts and the equities relevant to decision.

In addition, some of the comparative advantages of rulemaking have eroded in recent years. The modern practice of the courts has taught us that it is quite possible to announce prospective prescription in adjudication, and to allow liberal intervention and *amicus* briefing by nonparties. The *Federal Register* and the *Code of Federal Regulations* are not the concise reference books they were once thought to be; and commercial services increasingly render agency case law and summaries of agency case law more accessible. But most important of all, the procedural advantages of rulemaking for the agency itself are headed for extinction:

- The courts have attached many procedural requirements not explicit in the APA. These include the requirements that the agency publish and permit the public to comment on all data and studies on which it intends significantly to rely, and that the agency justify the rule in detail and respond to all substantial objections raised by the public comments. The "arbitrary and capricious" standard for judicial review has evolved from a lick-and-a-promise to a "hard look" by appellate courts.
- Congress has also roughened the procedural road, by requiring certain agencies to use adjudication-type procedures (including cross-examination), by prescribing for many rules the more rigorous "substantial evidence" test of judicial review, and by imposing on some rules a procedural burden beyond anything applicable to adjudication—the requirement that they be submitted to Congress for possible legislative veto. In the regulatory reform act that is sure to be enacted this year, Congress will almost certainly extend the first two of these innovations to all major rulemaking.
- Even the White House has helped to take the bloom off the rulemaking rose, by establishing a demanding and time-consuming process of regulatory analysis and Office of Management and Budget (OMB) clearance, applicable not only to new rules but, through a periodic review process, to old rules as well. (Regulatory analysis and periodic review of rules are

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also certain to be part of the 1981 regulatory reform act.) From the agencies' standpoint, the other advantages of rulemaking over adjudication would have to be considerable to outweigh the drawbacks of OMB clearance and mandatory periodic reevaluation.

The Ease of Returning to Adjudication

It is almost inconceivable that all these changes will not induce the wily (or even moderately intelligent) bureaucrat to do more of his thing through adjudication instead of rulemaking, if he is free to do so. And generally speaking, he is. Few agencies are compelled to act by rule.

It is almost inconceivable that all these changes will not induce the wily . . . bureaucrat to do more of his thing through adjudication instead of rulemaking. . . .

The Securities and Exchange Commission (SEC), for example, may conduct a rulemaking to declare a particular type of statement by brokers unlawful under the Securities Exchange Act; or it may achieve the same result by conducting an adjudicatory proceeding to revoke the registration of a particular broker on the basis that his making of such a statement was "false or misleading." Even the relatively few agencies that must act by rule often have room to shift meaningful prescription of law and policy into adjudication. The CPSC, for example, must establish product safety standards by rule; but if it phrases a standard at a level of sufficient generality ("Children's toys shall be designed to minimize risk of electrical shock"), then it effectively reserves the really significant decisions for the adjudicatory proceedings imposing sanctions for violation of the rule (establishing precisely what sort of electrical designs will pass commission muster).

It seems inevitable, therefore, that the recent encumberment of rulemaking will produce a renaissance of the previously favored mode of making law and policy—a movement back to basics, to adjudication. How simple that can be is demonstrated by the National Labor Relations Board, which will not have to undergo the transition because it has never stopped operating the old way. It has been a notable holdout in the trend to rulemaking, and has achieved that distinction by the simple expedient of nonaction—declining to issue rules, so that it is left free and, indeed, compelled to establish the content of the statutory prohibition of "unfair labor practices" in the individual grievance proceedings brought before it. That is all it will take for many other agencies as well.

It will be hard, at first, to observe the trend back to lawmaking by adjudication—but a recent example comes to mind. The "In Brief" section of *Regulation*'s March/April issue noted that the Department of Education's much-ballyhooed withdrawal of the Carter administration's proposed rule requiring bilingual education in public schools would not mean very much unless the policies which that rule embodied were repudiated—that is, the same results could be achieved without the rule by applying the same requirements to each of the adjudications concerning individual school districts' entitlement to federal funds. And that, it appears, is precisely what the Department of Education is about. According to Stewart Baker in the *Washington Post* (July 19, 1981), the department continues to force local school districts to sign agreements pledging to institute bilingual education, just as before.

Preventing the Return

By and large, the trend back to lawmaking by adjudication will be regarded as unfortunate. If one considers not *what* agencies do, but only *how* they do it, those who are regulated generally prefer the participation and certainty provided by rulemaking. (This may well be a short-sighted preference, in that it disregards the fact that the what and the how are connected—that is, the very nature of rulemaking encourages broader social planning.) But how to arrest the trend is by no means clear. One might think that the logical solution is to require agencies to adopt their general policies by rulemaking. That, however, is simply not practicable. To begin with, there is an irremediable ambiguity in the prescription. How "general" must a "general policy" be in order to qualify? If the Federal Communications

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Commission has a rule to the effect that "bad character" constitutes disqualification for a station license, must it further have a rule that "mob affiliations" constitute "bad character" before it can deny a license on that ground? Even if that problem could be overcome, the result of the new system would be to give every malefactor two bites at the apple, or at least a lengthy period in which to continue chewing. For example, the perpetrator of a new and imaginative type of stock fraud could not be stopped until a rule against that particular practice was first adopted and he was then found to have engaged in the practice after the adoption of the rule. No, the fact is that in many fields we want the agencies' determinations of law and policy to be applied retroactively.

An optional provision in the proposed Model State Administrative Procedure Act, now under consideration by the National Conference of Commissioners on Uniform State Laws, would solve this latter problem by permitting general policies to be adopted initially in adjudication, but requiring that the agency shall, "as soon as feasible and to the extent practicable, adopt rules to codify principles of law or policy lawfully declared by the agency as the basis for its decisions in particular cases." However, apart from the sheer magnitude of the task of such codification, there would remain the problem of vagueness: how generally applicable must an adjudicatory determination be in order to constitute a "principle of law or policy"? Suppose the agency says: "Speaking only to the circumstances of this particular case, we find that the acts alleged and proved by the agency staff constituted a violation of law." That establishes at least, does it not, a "principle" that whenever those circumstances are repeated there is a violation of law? If the subsequent rulemaking requirement does not apply to such a determination, then evasion of the requirement by merely particularizing the expression of decisions is easy enough. Or is it really evasion? The whole advantage of adjudication as a form of lawmaking is that it avoids the highest generality, proceeding gradually in an inductive fashion from one specific to another, in the context of concrete circumstances and on the basis of accumulated experience, so that a more and more general "principle of law or policy" is gradually formed. At what point along this spectrum does there come into being a "principle" within the meaning of the Model Act? And if that question can be answered, when is codification "feasible," and to what extent is it "practicable"? Finally, does not the whole process establish an inescapable dilemma as far as the perceived fairness of agency lawmaking is concerned? If the subsequent rulemakings regularly endorse the holdings of earlier adjudications, they will rightly be regarded as charades. But if, on the other hand, they often reverse (for the future) those holdings—which have been the basis for particularized commands or even penalties in the past—then the adjudicatory process is bound to fall into deserved disrepute. There is, in short, no satisfactory way either to abolish lawmaking through adjudication or to subject such lawmaking to subsequent rulemaking procedures.

The assumption that control of rulemaking constitutes control of lawmaking is simply not correct.

WHAT ALL THIS SUGGESTS, of course, is that the jubilation of regulatory reformers at having finally brought rulemaking under control should be somewhat restrained. The assumption that control of rulemaking constitutes control of lawmaking is simply not correct. To be sure, an evasion as blatant as the Department of Education's continued imposition of bilingualism, despite the withdrawal of the bilingualism rule, may well be caught and corrected. Ordinarily, however, such follow-up by the White House or OMB can hardly be expected. Indeed, in the future there will be nothing *to* follow up, since agencies will not be so foolish as to embody policies disfavored by the administration in rules in the first place! In restricting rulemaking, we may find that we have been squeezing the balloon of bureaucratic arbitrariness at one point, only to have it pop out somewhere else. The only sure way to reduce the thing is to let out some air—which is to say, to make the directives given the agencies in their substantive statutes less expansive and more precise. ■

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How to Get Less Timber and Less Wilderness at the Same Time

Wasting Our National Forests

Thomas M. Lenard

In recent years, increasing prices for wood products have focused attention on serious deficiencies in the way we manage our national forests. The increases have greatly exceeded the general inflation rate and have been a recurring problem in every expansion of housing construction since the late 1960s. Moreover, in coming years the demographic boom in housing demand will run up against the cyclical low point in timber production from private lands. Clearly, the problem will become worse, soon, unless new supplies are developed.

The obvious place to look for expanded timber production and relief from excessively high wood prices is the national forests. They contain over half of the nation's softwood sawtimber—the most important raw material for residential construction—but provide less than a quarter of the annual output. (In contrast, the private forest industry, which controls only 16 percent of the softwood sawtimber inventory, accounts for some 38 percent of wood production.) The strikingly low output from the national forests is caused mainly by the rigid adherence of the U.S. Forest Service to key policies that preclude efficient production. If the long-feared "timber famine" finally comes, it will in large measure be the result of poor management of public lands, not of alleged cut-and-run practices of private landowners.

The Forest Service has been severely criticized, from seemingly opposite standpoints, by both the timber industry and the environmentalists. However, the conflict between these two interests obscures a crucial point: the nation could have more timber *and* more wilderness if the constraints on efficient production were removed. Rational economic management would permit the production of more wood on less land, freeing large areas of national forest land for wilderness, recreation, and other purposes. Ironically, then, the present defective policies may be as harmful to environmental

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concerns as they are to the needs of the timber and housing industries.

Inefficiency and Controversy

Congress has recorded its intention, albeit somewhat ambiguously, that the national forests be managed with due regard for economic efficiency. Not only do the governing statutes contain numerous statements to this effect, but they also specifically call for a balancing of costs and benefits in national forest management—language that is conspicuously absent in many other areas of government activity. Despite this legislative intent, the results of Forest Service policy can scarcely be held up as a model of efficiency. Marion Clawson estimated several years ago that, if reasonable capital charges were assessed against the immense value of their resources, the national forests incurred annual shadow losses of $2 billion, even when noncash outputs like wilderness, watersheds, and recreation were generously valued. (The Forest Service ignores capital charges in its own calculations.) Put another way, the national forests earned less than 0.5 percent on their investment.

Inefficient management of the national forests is largely attributable to policies that require the maintenance of vastly excessive inventories of mature timber, that misallocate the land between timber and other uses, and that . . . preclude meaningful economic calculation. . . .

Efficiency losses of this magnitude, though not a visible issue in themselves, are clearly at the root of the controversy that surrounds national forest management. And the consequences of these losses—notably, higher wood prices—are both visible and painful. Seeking to relieve the problem, policy makers in Republican and Democratic administrations alike have looked to the national forests as a source of increased timber supplies. But, so far, all that they have managed to do is to generate vigorous opposition from the environmentalists. For instance, in 1973, during a period of rapidly rising wood prices, the Nixon administration attempted to increase federal timber sales by 1 billion board feet. The effort was halted by a Natural Resources Defense Council lawsuit, on the grounds that no proper environmental impact statement had been prepared. In 1979, during the most recent surge in lumber prices, President Carter directed the secretary of agriculture "to use maximum speed in updating land management plans on selected national forests with the objective of increasing the harvest of mature timber through *departure from the current nondeclining even-flow policy* . . ." (emphasis supplied). This initiative also failed to produce any apparent result. But, as we will see, it correctly focused on the "nondeclining even-flow" policy as the chief obstacle to increasing production.

Constraints on Efficiency

Inefficient management of the national forests is largely attributable to policies that require the maintenance of vastly excessive inventories of mature timber, that misallocate the land between timber and other uses, and that in general preclude meaningful economic calculation in land use planning. By far the most important of these policies is the "nondeclining even-flow" requirement, which arbitrarily limits the timber harvest in any one period and stretches it out for decades beyond the point of economic efficiency. In the process, significant amounts of otherwise useful timber are, in effect, wasted. This policy is perhaps the dominant factor in Forest Service planning.

A second damaging policy is the requirement that stands of timber not be harvested until they "generally have reached the culmination of mean annual increment." This cumbersome phrase simply means that trees cannot be cut until they reach the age that maximizes average annual growth. It is based on biological criteria and has no economic rationale. For economic purposes, timber should generally be harvested at a much younger age. This requirement is much less important than the "nondeclining even-flow" requirement, because our national forests already contain a large amount of timber that is substantially beyond the "culmination of mean annual increment"—timber that cannot be utilized efficiently because of the

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WHO would HAVE Thought that we would see
A policy of "spare that tree"
That would turn out to give us less
Of Lumber and of Wilderness?
DO NOT CUT UNTIL 3100 A.D.
THE GOVERNMENT JUST CAN'T GET ITS AXE TOGETHER!!
DO NOT CUT UNTIL 2023 A.D.
S.J. MASEK 1981

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even-flow constraint. If the latter rule is lifted, however, the former will remain as a hindrance to efficient harvesting.

Let us examine these policies—particularly the first—to see how they inhibit not only timber production, but also expansion in wilderness, recreational, and other uses of the national forests.

"Nondeclining Even-Flow." The clearest statement of this policy is from the National Forest Management Act of 1976:

> The Secretary of Agriculture shall limit the sale of timber from each national forest to a quantity equal to or less than a quantity which can be removed from such forest annually in perpetuity on a sustained-yield basis.

This policy puts a ceiling on the "allowable cut" that can be harvested now, basing it largely on the productivity of the forest at some distant date—perhaps several hundred years—in the future. Once that point is reached, the allowable cut would be no greater than the annual growth in that forest. The Forest Service, which had already been implementing this policy for several years when the 1976 act was passed, is free to depart from it "in order to meet multiple use objectives," but has never done so.

The adoption of sustained-yield or even-flow forestry as national policy probably stems in part from ancient fears about running out of timber. Such concerns were justified in the Middle Ages, when timber was a common property resource. With no great costs involved, people were tempted to cut too much of the wood for their own use, and thus deplete the forest. Although common ownership of the forests was never a problem in this country, the drawing down of excess timber inventories as the nation developed was (incorrectly) interpreted as evidence that the market would not work in forest land management. This belief contributed to the adoption of sustained-yield principles for managing the national forests. Of course, when timber is a private property resource—as it is in this country, even if much of it is publicly owned—forest owners will have the appropriate incentives to harvest and reforest at socially optimal rates. Indeed, analysis by Peter Berck suggests that private owners act as if they discount the future at a lower rate than is normally available on other investments, which implies that they have not been harvesting their timber prematurely.

At best (and then only under certain conditions), even-flow principles are suited to just one kind of forest, a forest with a balanced distribution of trees of different ages, from seedlings to mature timber. This is termed a "regulated" forest. Only in this setting can an even-flow policy produce what it is designed to produce—annual harvests equal to annual growth, indefinitely, brought about by cutting mature trees and replacing them with fast-growing young trees.

Vast tracts of the national forests are wholly unsuited to this kind of sustained-yield forestry, because they are not regulated, but rather contain a disproportionate amount of old growth—trees that have essentially reached their maximum volume per acre. Rigid application of the nondeclining even-flow principle is particularly troublesome for such forests. Particularly in the case of mature forests, faster cutting of old growth is needed in order to facilitate new growth and also to convert them more rapidly into regulated forests that can be harvested on a systematic basis. This would increase both present and future yields. The problem is that increased harvest in an old-growth forest will necessarily exceed the long-run sustained yield for some period, and this is prohibited by the requirement that there never be a drop-off in the harvest. In the face of the closed-circle policy, the nation is actually forgoing substantial timber supplies now in order to avoid the possibility of a reduction at some distant point in the future—but a reduction that would not necessarily bring future harvests below the levels implied by current policies. It makes no sense at all.

... faster cutting of old growth is needed in order to facilitate new growth and also to convert [mature forests] more rapidly into regulated forests that can be harvested on a systematic basis.

Since the allowable cut is limited by long-run growth (once the forest has reached a regulated state), the harvest of the old growth must be stretched out over a very long period

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in order to avoid a decline. This substantially decreases the economic value of the timber. Peter Berck's analysis indicated that holding old-growth timber for fifty additional years on a good site involves a shadow loss of 45 percent of the timber's value, or nearly $6,000 an acre. If the volume of old-growth timber is larger than can be metered out over time without exceeding the even-flow constraint, substantial losses of usable volume can occur. There is also, of course, an additional physical loss, as insects, disease, fire, and age destroy some of the old standing timber.

The nondeclining even-flow policy has other nonsensical implications. For instance, simply redrawing the boundaries of planning areas so as to combine mature stands with young faster-growing trees would allow increased harvest of the older timber. Where rational management fails, fiddling with a map could succeed! By law, however, the planning areas coincide with the national forests.

To take another example, suppose the Forest Service makes an investment in intensive forestry in an immature timber stand in an area that also contains mature timber. Under nondeclining even-flow reasoning, the investment, which would enhance future yields, allows an immediate increase in the harvest of the mature timber (this is known as the "allowable cut effect"). The increase in current production in the short run is then included in the return on the investment in intensive forestry. Returns on this sort of investment tend to be fabulous. Of course, the availability of mature harvestable timber in this situation has nothing to do with the investment and cannot legitimately be added to the investment return. Moreover, if more rational calculations were used, the investment might not be economically desirable.

An argument often advanced in favor of even-flow management is that a steady harvest of public timber promotes social and economic stability in the surrounding communities. But this claim neglects the fact that many of these communities are also dependent on private timber, which is not provided at a constant rate. For example, the output from private lands in the Pacific Northwest—an area with large amounts of old-growth national forest timber and with substantial mill capacity—is expected to decrease in coming years. But the nondeclining even-flow constraint does not permit increased timber sales from the public lands to offset declines in private harvest.

Similarly, the even-flow idea makes no provision at all for slowing or accelerating the harvest to meet changing market demand. This is particularly relevant at the present time. The arrival of the children of the postwar baby boom at home-buying age has greatly increased the demand for new homes and thus for lumber, a problem that will be exacerbated by the anticipated decline in timber output from private lands. Given fluctuations in market conditions, clearly a steady output of public timber cannot guarantee a secure economic base for communities dependent on timber output, or achieve stable prices for wood products.

Most important, the even-flow requirement does not allow decisions to be based on economically valid calculations of the benefits and costs of alternative forest management plans. Adopting the simplistic idea of a sustained yield institutionalizes this basic shortcoming. What results is rigid and uncomprehending application of policy, when what is needed is flexible and rational management that can respond to ever-changing economic realities.

"Culmination of Mean Annual Increment." The other policy in question, also stated in the National Forest Management Act, prohibits the sale of timber from national forests before the stands have reached their maximum average annual growth, or "culmination of mean annual increment." Here, too, the Forest Service is permitted to relax this requirement, but has not done so to any significant extent.

This second policy is conceptually linked to the first. The idea is that when timber reaches the point of its fastest average annual growth, the long-run sustainable yield or allowable cut is the highest possible under the even-flow rules. The purpose of this provision is to maximize the continuous physical output of wood from a given area; all sales are prohibited before this point is reached. Although this constraint is of secondary interest, because large amounts of national forest timber are substantially beyond the culmination of mean annual increment, it provides another example of an inflexible rule devoid of any economic rationale. It also may, for essentially technical reasons, make the nondeclining even-flow constraint more restrictive.

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The problem with this policy is that it ignores the time value of money. The way the Forest Service looks at these decisions, it makes no difference whether you harvest a tree now, in fifty years, or in a hundred years. When realistic interest rates are taken into account, however, it does make a difference. Timber reaches its maximum *economic* value—called "economic maturity"—many years before it reaches its maximum average annual growth. Thus, economically rational harvesting uses a much shorter rotation period, often shorter by decades. This is generally the practice in industrial forestry.

The cost of the two policies, as illustrated by John Walker's analysis of alternative land use plans for the Stanislaus National Forest in California, is large: the approved plan for that forest is costing society $270 million (see table). In fact, in this example at least, the two constraints make society worse off than if the forest were operated by a profit-maximizing monopolist. These results frustrate the purposes of the Multiple-Use Sustained-Yield Act of 1960, which provides that national forest resources shall be used "in the combination that will best meet the needs of the American people. . . ."

Wilderness and Development

While it is clear that the policies discussed thwart the efficient production of wood from the national forests, it does not automatically follow that they are unjustified. A case could still be made for them if they sufficiently enhanced other, nontimber outputs—wilderness, wildlife, watersheds, forage, recreation, and so on—and in fact, the Forest Service sometimes defends its practices on these grounds. But no persuasive evidence of this has been advanced. Indeed, the evidence runs the other way. For example, Walker finds "no demonstrable benefits" of that sort to offset the costs of the approved Stanislaus plan. A study by Steven Calish, Roger Fight, and Dennis Teeguarden concluded that waiting for culmination of mean annual increment is not justified by enhancement of nontimber values, and that "economic rotations [harvest at the point of economic maturity] may do a good job of providing for the nontimber benefits. . . ." Clawson believes that "good management could provide much more of each kind of output," a subject we turn to now.

Efforts to give wilderness status to national forest areas have provoked heated political dispute and are a source of great uncertainty for the timber industry. At the present time, Congress is considering a bill (S. 842) that would help resolve questions about the status of the 62 million acres of undeveloped national forest land studied for possible wilderness designation in the Agriculture Department's second roadless area review and evaluation (submitted to Congress in 1979). Decisions on such allocations are often thought to be difficult because, while timber has an identifiable market value, other forest outputs like wilderness are nearly impossible to quantify in dollar terms. But those decisions become easier once it is recognized that, by removing the constraints on efficient timber production, the nation can have more timber and more wilderness at the same time.

One obvious step is to allocate national forest lands according to their greatest value, a step fully justified by the statutes. In practice, however, the policies we have examined are applied to all national forests, with little regard for the great differences among them. The result is that timber harvesting is spread throughout the forests, in spite of convincing evidence that concentrating timber activities in the most productive areas would enhance both economic and environmental values. William F. Hyde's supply projections for the Douglas fir region of Oregon and Washington, one of

COMPARISON OF ALTERNATIVE PLANS FOR THE STANISLAUS NATIONAL FOREST

Plans	Initial Harvest Levels (hundred thousand cubic feet/yr)	Present Value of Net Social Benefits[a] ($ millions)
Approved Forest Service Plan	186.5	418.0
Rigid Even-flow Plan[b]	198.1	470.7
Monopolist's Optimum[c]	260.1	595.4
Social Optimum[d]	442.1	690.8

a Based on 6 percent interest rate.
b Sets harvests at a level that can be maintained in perpetuity without cutting any stand before "culmination of mean annual increment"; differs from the Forest Service plan mainly in the order in which stands are cut.
c Maximizes the present value of the net cash flow accruing to the Forest Service.
d Maximizes present value of net social benefits.
Source: John L. Walker, "Land Use Planning Applications of the Economic Harvest (ECHO) Model."

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the most productive timber areas in the country, show that if the present constraints were removed, wood production from public lands could be increased by 74 percent, using 27 percent fewer acres. This would *triple* the amount of forest land in the area on which timber harvesting is not permitted. Hyde concludes: "Efficient timber production is a strong argument for wilderness." It is worth mentioning that a change of this sort, increasing both wood production and wilderness, also creates a de facto timber reserve in the wilderness area that may help allay fears that we will run out of timber in the future.

. . . if the present constraints were removed, wood production from public lands could be increased by 74 percent, using 27 percent fewer acres. . . . "Efficient timber production is a strong argument for wilderness."

The basic problem, Hyde argues, is that the more productive timber lands are not managed efficiently, while inefficient timber lands are kept in production. Removing the latter from production would result in a net saving to the Treasury, since the cost of production in those areas is greater than the revenues. Moreover, road construction—a major source of environmental damage as well as expense—would be reduced. Finally, as Hyde points out, the less productive areas are often both desirable for recreational purposes and most vulnerable to environmental damage under timber management.

Other investigators have reached similar conclusions. Walker found that by relaxing the constraints on efficient production in the Stanislaus National Forest, more wood could be produced and more land devoted to nontimber uses. Clawson concluded that Forest Service costs exceeded returns on low-productivity sites.

Concern about the timber harvest on low-productivity lands has also been voiced by environmental groups. Kurt Kutay's study of western Oregon showed that a different allocation of Forest Service funds could produce more wood for no increase in cost, and would also allow more roadless land. The Natural Resources Defense Council has argued that an economic test is required to identify lands "not suited for timber production" (section 6(k) of the National Forest Management Act), and urges that such lands be withdrawn from production. However, that organization stops short of recommending more intensive harvesting of productive sites. Thus, while there are similarities between an economic and an environmentalist point of view, there are also significant differences.

Failure to allocate the land properly is largely attributable to the nondeclining even-flow policy. This policy creates an incentive to keep unproductive lands under harvest, since removing these areas from production would result in an immediate decrease in the allowable cut. It also creates an incentive to overinvest in some areas, on the artificial grounds that such investment, by increasing future yield, offers a greater immediate return in the form of an increased allowable cut. Given the limited Forest Service budget, this propensity to overinvest in some areas naturally leads to underinvestment in other areas where rational economic planning would call for intensified effort. Both over- and underinvestments are magnified by the political necessity of distributing the available funds "fairly" throughout the national forest system. Finally, and most damaging, the policy prevents an accelerated harvest of the vast amounts of mature timber on national forest lands and thus precludes the use of efficient technologies in those areas.

Some Conclusions

To argue that a fundamental change in national forest policies will provide more of seemingly conflicting outputs is not to say that trade-offs never need to be made. There are, for instance, demands for wilderness in areas where timber production is profitable and promising. There may also be conflicts between mineral development (a subject beyond the scope of this discussion) and other forest uses. When such conflicts arise, decisions should be based on the relative value of the land in its several uses. This, indeed, is what the statutes suggest. The fact that there may be legitimate conflicts concerning the uses of public land makes it all the more important to exploit every opportunity to

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remove uneconomic procedures and to make better use of all the potentials of the land.

Although thoroughgoing reform will be difficult to achieve, all that is really required is the application of benefit-cost analysis to Forest Service planning. This would be consistent with the multiple-use principles mandated by Congress and with President Reagan's executive order on federal regulation. There are clearly practical problems in applying benefit-cost analysis to this area, but it could be done—and, if done properly, would take into account both the monetary and nonmonetary values of national forest resources. Its basic purpose would be to ensure that the trade-offs among the various forest resources, and the costs and benefits of alternative management plans, were made explicit. As a benchmark, planners could be required to develop a completely unconstrained management plan. That is, they would ask the question—how would a competitive forest products company manage this land? Then, as constraints were added to take account of nonmonetary values, the cost of those constraints could be identified. The public as well as the officials who set final policy would then have adequate information on which to base their decisions.

It is also important to recognize that the relative values of forest resources, and therefore the optimal use of forest lands, may change over time. For this reason, policy should be flexible. While it is often claimed that wilderness areas preserve options for the future, in fact it is extremely difficult to reverse a wilderness designation once established. The result, unless attitudes toward wilderness areas change drastically in the future, is not to preserve options, but to slam the door on potential productivity from these areas in years ahead. Thus, assigning lands to de facto wilderness status—if that is their best current use—may be a better way to preserve future options.

In a word, more flexibility—more plain common sense, if you will—is the foremost need of national forest management. The problems we have discussed all relate directly to inflexible policies applied in many wholly inappropriate situations. But for this inflexibility, the national forests would provide the nation not only with far more timber, but with more wilderness, recreational areas, and other resources as well. It seems most unfortunate that we cannot enjoy the full output of the national forests when it is there just for the asking.

Lastly—a point of more than passing interest to the readers of this magazine—there is perhaps a lesson that can be drawn from our experience with national forest policies. It is this: Statutory language that specifically encourages economic efficiency and benefit-cost balancing is not enough to produce the desired result. The statutes governing national forest management contain much of the type of language that many would like to see in other regulatory measures. But that has not done the job. It would seem that such statutes must either unambiguously specify economic efficiency as the primary objective, or be administered by people who hold that view. ■

Statutory language that specifically encourages economic efficiency and benefit-cost balancing [in forest management] is not enough to produce the desired result.

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Protection for Petroleum Refiners?

Edward J. Mitchell

BARRING NEW LEGISLATION, the United States has moved into an era of unsubsidized, unprotected, and uncontrolled oil markets. With President Reagan's removal of price and allocation controls, the lone remaining government intrusion is the "windfall profits tax," in reality an excise tax on domestic crude oil production. Gone are the depletion allowance, the oil import quota and, with the latter, effective control over domestic production by state regulatory commissions.

But before anyone cries "free at last," there is one final battle to be fought. As in any regulatory drama, the cast of this one is replete with industry beneficiaries who do not easily give up their government subsidies. Some smaller refiners, favored by government programs for more than two decades, are now lobbying for assorted new protections and subsidies, foremost among them a form of allocation control that would operate in periods when imported crude was in short supply. For anyone who might believe that such controls would be temporary once installed, it should be pointed out that the allocation controls on crude oil that the President recently removed were first legislated by Congress in November 1973, in something called the Emergency Petroleum Allocation Act. In this business "emergencies" are long-lived.

Thus, the current debate within Congress over whether to establish government allocation of crude oil and refined products for "emergencies" or "supply shortfalls," however those are defined, could have more than a transitory effect on the petroleum market. Philosophically, the issue divides those who believe free markets always work best from those who believe they work poorly under conditions of supply shortfalls. At the more mundane level of self-interest, the issue divides the integrated refiners, who own or have firm contracts for foreign and domestic crude supplies, from the non-integrated refiners, who have opted to take their chances in the spot markets, winning when crude is abundant and losing when it is scarce. Non-integrated refiners want a program to allocate some of the cheaper crude to them when spot crude is scarce. Their proposals are based on what they believe are imperfections in the oil markets that result in unfair competi-

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tion among refiners, shortages or high prices to consumers, and dependence on unreliable sources of petroleum products.

The General Case for Assisting Domestic Refiners

Supporters of allocation argue that, until recently, crude oil has always been available to the independent refiner, but that changes in the world market, in particular the use of direct sales to consuming nations and the reduction in arms-length sales by major oil companies, have left a much narrower market available to independent refiners. Since no refiner can operate successfully at less than a high percentage of capacity, some independent refiners may find themselves disadvantaged by a lack of raw material. As a result, an efficient and otherwise economically viable refiner may find itself bypassed by the world crude oil distribution system, with competition and economy reduced as a result.

The second issue raised by supporters of allocation concerns the reliability and competitiveness of imported petroleum products. (Over the last two decades, U.S. refiners were protected from foreign competition, first by import quotas and then by entitlement subsidies under the subsequent price control programs.) It is said that having to import refined petroleum products carries with it a national security risk similar to that involved in having to import crude oil. Furthermore, foreign refineries allegedly possess certain artificial advantages, such as lower pollution control costs and freedom from the Jones Act requirement to use more costly U.S. tankers.

Finally, it is claimed that because of changes in the demand for refined products, domestic refining is becoming unprofitable at the very time that refiners should be making investments in new capacity to meet that changing demand. This seeming paradox could lead to product shortages unless government action is taken.

The proposals for government action put forward at congressional hearings follow these concerns closely, calling for: (1) a systematic program of redistributing access to crude oil supplies in order to equalize availability or price or both; (2) tariffs or import fees to shelter U.S. refiners from foreign competition; and (3) assorted tax incentives to make new refinery investment in the United States attractive.

In my view, each of these proposals is anticompetitive and would be costly to the American consumer. What they would do is not equalize the relative positions of independent refiners and major refiners, or U.S. and foreign refiners, but subsidize independent and domestic refiners without economic or national security justification. The disadvantages faced by domestic independent refiners, alleged to be artificial in some sense, are in fact primarily real. In some cases the disadvantages are technical, deriving from the scale of operations; in other cases they are organizational or managerial, the result of past business decisions. In any event, they surface at this time because the regulations and subsidies that have hidden them for more than two decades are now gone and refiners are exposed to the bright light of free market competition.

The State of Refinery Economics

Before we can deal with policy questions, we must understand where we are and how we got there. In the past decade, rising crude oil prices have raised prices of refined products to the point where the volume of these products that consumers now wish to buy falls far short of existing refining capacity. In other words, there is a world-wide glut of refinery capacity. Table 1 indicates how low the levels of capacity utilization have been around the world in recent years. These low rates are the natural result of higher crude prices. In general, a rise in the price of any particular factor of production reduces the demand for, and hence the value of, all complementary factors. Thus, the rise in crude prices has created a glut of tankers, pipelines, and gasoline stations, as well as refineries. This is not to say that each specific

Table 1
UTILIZATION RATES OF REFINERY CAPACITY, SIX COUNTRIES, 1979–80

Country	Rate of Utilization 1979	1980
Italy	48%	48%
Netherlands	65	62
W. Germany	71	66
United Kingdom	77	63
Japan	80	73
United States	83	74

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complementary asset faces a drop in demand. Within the overall trends there are always subcurrents running in the other direction. Demand for light products such as gasoline will remain strong and the need for conversion capacity to yield unleaded gasoline will actually grow. But the underlying condition is general overabundance of refinery capacity.

The natural economic consequence of this is retrenchment. Some refineries will close as their profit margins fail to cover operating or variable costs. Which refineries these will be depends upon a host of factors, including the technical efficiency of the plant, its location, its product mix and required crude inputs, and, not least of all, the entrepreneurial abilities of its owners or managers. The process of retrenchment to a new equilibrium has been going on among foreign refiners, but not here, ever since the Arab embargo of 1973. It did not occur here because domestic refining capacity was sheltered from foreign competition, mainly through the entitlements subsidy, which gave all domestic refiners crude oil at prices below the world market. Note in Table 1 the relatively high levels of capacity utilization that U.S. refiners enjoyed in 1979–80. Even as late as January 1, 1981, in fact, they were operating at more than 77 percent of capacity. But this fell sharply with decontrol, reaching 67 percent for the week of July 17, 1981.

More than this, a specific class of refiners has been sheltered from even domestic competition—primarily by means of the "small refiner bias" that existed under both the entitlements program and the earlier Mandatory Oil Import Program. Because small refiners have been doubly sheltered, the adjustment to decontrol required of them is doubly severe.

Non-integrated refiners argue now that they are technically efficient firms with low or moderate operating costs, as long as they can obtain raw material on equal terms with integrated refiners. This is a specious argument. The economic measure of a firm is not its technical or engineering efficiency, but its ability to convert the least costly inputs into the most valued outputs. To succeed, entrepreneurs must be good at buying inputs and selling outputs. Otherwise, they should be employed as engineers, not as entrepreneurs. Refinery capacity that is efficient and well-located will in fact be utilized because it will, through employment policy, sale, or merger, come under the control of better managers. In the end, the market will give us those combinations of equipment and managers that yield the lowest overall costs.

Equal Access

It is of course true that non-integrated refiners have more trouble keeping their refineries operating at high levels of utilization than integrated refiners, especially when crude oil is temporarily scarce. This is said to be a disadvantage to non-integrated refiners, which it certainly is, and thus a justification for government intervention to compensate for the disadvantage, lest efficient capacity lie idle and competition diminish.

But all business decisions have advantages and disadvantages. If they did not, making business decisions would be easy and decision makers would not be as well paid as they are. The advantage of buying crude in spot markets is that it has generally been cheaper there because those markets give refiners unlimited flexibility in their search for the best deal available at any particular moment. The disadvantage is that, in tight spot markets, crude may be more expensive and certainly is harder to come by than crude that is assured by long-term contract.

If the present disadvantages of past business decisions were an acceptable rationale for special assistance, however, integrated refiners would have to be subsidized in periods of crude abundance when spot prices fall below long-term contract prices. A symmetrical buy-sell program would have to be instituted that required non-integrated refiners to share the benefits of low spot prices with integrated refiners. More generally, all business decisions would have to be subsidized by government programs that distributed the advantages of "correct" decisions (at any point in time) to all competing businesses that had made "incorrect" decisions. It is easy to see what the outcome of that approach would be: there would be no incentive for any firm to make the correct decision, since any benefits would be distributed among all competitors.

A high quality of access to crude oil costs more than a low quality of access. Refiners who complain that they cannot conclude long-

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term deals with foreign producing governments, because those governments require capital investments or tie-ins of various sorts, are merely recognizing the high price of access. It is understandable why they would prefer to acquire this access by having our government seize it from those who have already chosen to pay for it; it is not understandable why anyone would regard this as equitable.

But regardless of equity, such a program is clearly inefficient. Who would buy a high quality of access to foreign crude if the government could redistribute part of that crude without compensation? The proposal for a systematic program to redistribute high-quality access is a prescription for collective non-access. Such a program would run directly counter to one of the few unanimously held positions on national energy policy: the need for security of crude oil supplies.

The point is that to purchase or not to purchase quality access to crude oil is a business decision. Refiners do not come into the world integrated or non-integrated. They choose to become one or the other, and they will make the right choice only if they bear the costs and benefits of that choice.

Price and Availability in the Spot Market

A serious misconception about the world oil market is the belief that in "supply crises"—that is, temporary reductions in crude oil imports—"hectic" or "frantic" competition for limited spot market supplies results from the fact that refiners with insecure supplies must buy in that market. If those refiners had more secure supplies, it is thought, spot prices would not be bid up so high and official export prices would be restrained.

The fact is that the spot market does not care who buys in it or what fractions of the buyers' supplies are secure or insecure. It is the total demand for crude less the supply of crude from non-spot markets that determines demand on the spot markets. The same price will be realized whether the particular purchasers in that market are integrated or non-integrated refiners, "majors" or "independents," small or large, Americans or Germans. The mere shifting around of secure supplies from one refiner to another, or one nation to another, does not change the demand for spot market crude. That demand can be reduced only by policies such as tariffs, which act directly on consumer demand, or by providing temporary increments to supply from inventories and thus reducing the need to buy in the spot market.

Ultimately, the reason for this is that the demand for oil does not originate with refiners or nations, but with hundreds of millions of individuals. No matter who acts as their intermediary, they will demand the same quantity of oil at any given price. The notion that equal access can help reduce "frantic" buying and hold down spot prices implies that shuffling the identities of the agents who purchase oil for consumers can significantly affect the market price of oil. Indeed, it implies that "majors" can buy a given amount of oil on the spot market more cheaply than "independents" can. This does not augur well for the "independents," since that is the market in which they must be superior buyers if they choose to remain non-integrated.

There is a further mistake in this argument. It assumes that the spot market price *determines* the official contract price of crude set by exporting countries. While it is true that producing nations watch the Rotterdam spot market price closely and indeed have followed that price with a lag in setting their official prices, it is incorrect to infer that the Rotterdam price *causes* the official price to be what it is. The spot market price is a function of overall supply and demand. The major producing nations, in particular Saudi Arabia, determine the supply. The Rotterdam price tells them how their production decisions have translated into market prices. The spot price is, therefore, a barometer measuring the price implications of their production decisions. If the spot price does not suit them, they will change their production decision so that it does. Thus, the causation in a cartel situation—more properly, a dominant producer situation—such as this runs from the supply or production decision to price, not the other way around.

If someone says that holding down spot prices during the past crises would have held down official contract prices, he must tell us where production would be greater today. Lower long-term prices require greater long-term production. Where today would production be greater if spot prices had somehow been lower during the past crises? This ques-

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tion is difficult if not impossible to answer. There is no reason, therefore, to believe that a buy-sell program would have any favorable effect on world or U.S. crude or product prices.

While the insecurity of crude oil supplies has grown over the last decade, pushing even non-integrated refiners to lock up secure supplies, reliance on the spot market for some purchases is inevitable. It is fortunate, therefore, that this market has grown considerably during the same period. Since the Arab embargo, volumes traded on the so-called Rotterdam market have increased considerably. Open market sales of crude by producing nations—in contrast to nation-to-nation sales and parent company sales to affiliates—have grown from 7.7 M b/d in 1973 to 11.2 M b/d in 1979, or from 25 percent to 37 percent of the world crude oil market. This calls attention to the fact that insecurity of supplies implies not so much inability to obtain crude as inability to obtain it at a desired price. The vulnerability of the non-integrated refiner after decontrol is primarily a vulnerability to highly variable prices.

The Paradox of Profit and Loss

For some observers, there is a paradox in the simultaneous existence of low profitability for refining in the post-control situation and the need for new investment. This contradiction suggests to them that special incentives are needed to upgrade U.S. refineries.

The paradox is, however, only apparent. The lack of profitability and the need for investment refer to two different things. Distillation capacity, which yields a product mix slanted toward fuel oil and other heavy products, is unprofitable; conversion capacity, which upgrades heavy products such as fuel oil into more valuable light products such as gasoline and jet fuel, is and will be profitable. In an unregulated and unsubsidized market, distillation capacity will be reduced and conversion capacity will be expanded in response to their relative demands and profitability.

Concentration and Competition after Decontrol

One of the arguments used to justify assistance to the "independent" refiners, either by guaranteeing them access to supplies or by providing some other subsidy, is that the existence of a large "independent" segment of the market increases competition. Part of the folklore of the petroleum market is that "independent" refiners provide a degree of competition disproportionate to their size. The absence of systematic research demonstrating that the "independents" play that kind of special role leaves the idea at best a hypothesis, and not a working assumption.

Compared to other industries in the United States, the degree of concentration in petroleum refining has always been moderate. In 1978, the four-firm concentration ratio for U.S. refiners was 32 percent (that is, the largest four firms accounted for 32 percent of all crude oil run through industry refineries), and the eight-firm ratio was 56 percent. With decontrol placing the industry squarely in the world refining market, the degree of effective concentration will be reduced even further. In 1978, the four-firm concentration ratio for world refining was about 22–23 percent, the eight-firm ratio about 33–35 percent. Transportation costs are relatively low in world petroleum trade and products flow quickly whenever price discrepancies open up. The domestic industry will be exposed to a huge export refinery capacity built in recent decades in the Caribbean, Mediterranean, and northern Europe. In the one refined product where free trade has been allowed in this country, residual fuel oil imports into the East Coast, U.S. prices are totally determined by the sum of foreign export prices and transportation costs. And while import volumes of lighter products are not apt to be as large as those of residual fuel oil, the vast capacity abroad will exert enormous competitive pressure on the U.S. market. The size of the domestic "independent" sector would seem to be an exceedingly minor factor in the context of this world market. Complete disappearance of the U.S. "independents"—something that is never going to happen—would raise the low world concentration ratios by at most a percentage point or two.

A more fundamental question is raised, however, when a subsidy is considered to help one segment of an industry compete with another. The economic purpose of competition is to select the lowest-cost firms and force them to pass their low costs on to consumers. Competitors that require subsidies to compete are not in fact low-cost firms. Subsidizing them

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supports inefficiency, not efficiency. For this reason, academic economists condemn proposals to induce competition by protecting or preserving certain competitors.

Competition from Foreign Refiners

Finally, several miscellaneous arguments have been put forward in favor of protecting the domestic refining industry as a whole. First, it is said that the Jones Act, which requires that goods moving between U.S. ports be carried in more expensive U.S. tankers, artificially increases transport costs for U.S. refiners. Thus Gulf Coast refiners must use U.S. tankers to ship to the East Coast, while Caribbean and European refiners may use foreign tankers. Second, it is claimed that, in general, the anti-pollution requirements U.S. refiners have to comply with are stiffer and more expensive than those of their foreign competitors. Finally, it is said that reliance on foreign refiners compounds the crude oil insecurity problem. These arguments have led some to recommend a tariff on imported petroleum products (but not on crude).

The Jones Act requirement is an artificial disadvantage. Table 2 shows the cost of shipping a barrel of refined petroleum to the U.S. East Coast from various points in the world. By using cheaper foreign tankers, foreign refiners are able to offset substantially, and sometimes completely, the longer distances over which they must ship. But this disadvantage occurs rarely, because only 8 percent of U.S. petroleum product shipments are affected by the Jones Act. Moreover, it is a disadvantage shared by all other U.S. water shipments, none of which would be protected by a tariff on petroleum products. There is only one thing to do with the Jones Act, and that is to repeal it.

The more severe anti-pollution requirements imposed on U.S. refiners do, however, constitute a real disadvantage. Environmental costs are greater for U.S. refiners because our political system has made the judgment that the costs of allowing pollution to continue unabated would exceed the costs of cleanup. Some other governments have placed a much smaller value on anti-pollution activities. While refiners in any country may legitimately argue about the level of environmental standards, the costs associated with anti-pollution activities represent as real a social cost as payments for wages and capital.

Table 2
TANKER RATES TO THE U.S. EAST COAST, 1980

Point of Origin	Per Barrel Rates for Clean Cargoes: Year 1980	Per Barrel Rates for Clean Cargoes: October 1980
U.S. Gulf Coast	$2.32	$2.46
Caribbean	1.71	1.40
Mediterranean	2.60	1.79
Rotterdam	2.50	2.25

The argument that foreign refinery capacity creates a security problem has been especially vague. To begin with, there is currently a glut of refinery capacity throughout the world. Moreover, this capacity, unlike crude production capacity, is not concentrated; it is scattered through the Caribbean, northern and southern Europe, South America, and elsewhere. Third, if the most plausible of the possible supply interruptions should occur—a curtailment of crude from the Persian Gulf—there would be an even greater glut of capacity, and especially of conversion capacity, since Persian Gulf crudes are of only average quality while the high quality, lighter North African and Indonesian crudes would be unaffected.

Thus, the case for a protective tariff on grounds of either artificial economic disadvantages or real security risks is thin. There are reasonable cases that can be made for a tariff on imported crude, either on a temporary basis during supply interruptions (the so-called disruption tariff) or as a long-term measure to reduce the demand for imports and the associated risks. But these proposals have nothing to do with a purely protective tariff on refined products.

THE ARGUMENTS for special assistance to domestic refiners, or just to domestic non-integrated refiners, are based primarily on economic misconceptions. Unfortunately, weak arguments have not been a serious hindrance to the cause of domestic refinery protectionism in the past, as the record of the last six administrations shows. But this administration is seeking to forestall protection. Can President Reagan persuade Congress to go along? ■

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THE CO$T OF GETTING NOWHERE AT THE FTC

Bruce Yandle

IN A THIRTY-MINUTE public meeting on February 11, 1981, the five members of the Federal Trade Commission (FTC) unanimously rejected a proposed trade regulation rule governing the advertising of over-the-counter drugs. Thus ended a proceeding that had run for five years and three months, at immense cost to all involved. The FTC had devoted 19,058 staff hours to it (through 1979), and paid an additional $61,000 for the expenses of "public interest" participants. One trade association representing a combination of interests had spent over $2 million in administrative and legal costs, and other associations had spent lesser, but still significant, amounts. The record generated by this effort included 4,230 pages of hearing transcript, 2,300 pages of documents submitted by FTC staff, and 6,000 pages of statements, exhibits, and rebuttal comments by outsiders. The informal hearings alone lasted more than a month and included the testimony of some fifty expert witnesses of various kinds.

On first reading about the decision, one may have an impulse to feel grateful that the commission declined an opportunity to issue a bad rule. The expenditure of so much time and money could easily have created a strong bias to do something—anything—to justify it. But the impulse should be suppressed, for it only shows how completely mistrust has come to dominate one's expectations about regulatory procedures. There are many ideas for regulation in the world and so many of them are wrong that weeding out bad proposals should be routine business for agency regulators—not deserving of much acclaim.

The most important issues here concern not the final result, but how the FTC got there. More precisely, there are two main questions: (1) What did the FTC know at the end that it did not know at the beginning? In other words, was the long proceeding necessary to the final decision? (2) Did the proceeding settle anything? That is, can one be confident that the agency has incorporated the principles that led to rejection into any general policy or even into its institutional memory?

The answers seem to be, respectively, "nothing" and "no." This is especially troubling because the rulemaking was conducted under the procedures of the Magnuson-Moss Act of 1975, which require the FTC to conduct oral hearings, to allow cross-examination and rebuttal with respect to crucial facts, and to engage in various kinds of economic analysis. The theory of the Magnuson-Moss procedures—similar to that of many current proposals for general regulatory reform—is to allow interested persons to test the commission's facts and concepts, thus improving its factual base and its decisions as well. If, in practice, such procedural requirements produce nothing but expensive records unrelated to any final decision, that fact is worth thinking about.

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The Proposed Rule

The FTC's rulemaking was announced on November 11, 1975. It was an outgrowth of a program at the Food and Drug Administration (FDA) to review all over-the-counter (OTC) drugs, with an eye to banning the ineffective ones and, for the others, prohibiting the use on product labels of claims found not to be scientifically supportable.* The FTC reasoned, in accord with its long-standing insistence that advertising claims be substantiated, that if the FDA decides not to allow drug makers to make a certain claim on their labels, the FTC should not allow them to make it in their general advertising to the public. Thus the FTC proposed a rule forbidding any claim in the advertising of an OTC drug that the FDA commissioner "has determined . . . may not appear in the labeling of such drug."

Only a month after the FTC launched the proceeding, the Bureau of Consumer Protection (which had instigated the rulemaking) moved toward a strict interpretation of the language quoted above. Instead of simply requiring that advertisers use language whose substance reflects label claims with sufficient accuracy, the staff concluded that nothing but the exact label language emerging from the FDA's OTC reviews should be acceptable under the rule. As the FTC's assistant director for national advertising described the idea at a conference in December of that year, the commission's proposed rule

> would have the same effects as [the FDA's]. With respect to antacids, it would prohibit advertisers from stating indications for use other than those enumerated by FDA, and from using language other than the language set forth by [the FDA].

This interpretation made the proceeding an exercise in semantics, an inquiry into the nature of synonymy. If many alternative wordings convey to the consumer the same impression as those chosen by the FDA, it would be hard for the commission to argue that those alternatives were deceptive or their use unfair. At the limit, the FTC staff needed to establish the unique nature of every word that drug advertisers are likely to use, while its opponents needed to establish the almost infinite number of ways in which one can make truthful claims.

In a less-than-sparkling beginning for an inquiry into linguistic clarity, the FTC's proposed advertising regulation dated September 16, 1976, set forth the issues as follows:

> (1) In general, what is the likelihood that there is terminology, or that terminology can be devised, that will mean the same to consumers as the terminology approved by the Food and Drug Administration?
>
> (2) If there is or can be devised such terminology, will advertisements utilizing that terminology be likely to convey the same meanings to consumers as (a) the Food and Drug Administration approved terminology or (b) the same advertisements using only the Food and Drug Administration approved terminology?
>
> (3) Are measures available to establish that advertisements utilizing those terms will convey to consumers the same meaning as (a) the Food and Drug Administration approved terminology or (b) the same advertisements using only the Food and Drug Administration approved terminology?

Let Me Call You Hyperosmotic

Under the strict interpretation, in other words, the vocabulary choice available to advertisers would be frustratingly narrow. For example, after its review of antacids the FDA approved just four terms—"antacid," "heartburn," "acid indigestion," and "sour stomach"—for antacid labeling. Thus the FTC would police ad copy for nuances of meaning not present in those terms; and it would be a civil offense carrying a $10,000 penalty for a manufacturer to tell consumers through advertising that its antacid "relieves stomach misery due to excess stomach acid" or "relieves excess gastric acidity."

Consumers, for their part, might find some of the "deceptive" phrases more informative and useful than the approved phrases. Among the terms approved by the FDA for label claims are "antiflatulent," "antiemetic," "antitussive," and "hyperosmotic." According to a psychologist testifying for the OTC drug industry, survey data indicate that only 14 percent of the adult population understand "antiemetic," and even fewer understand "antitussive." Former

*The FDA began this program in 1972 and has now completed its review of about a dozen of the seventy-odd categories involved.

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FDA Commissioner Sherwin Gardner, testifying in the proceeding, suggested that the use of such words in advertising might itself be deceptive, an example of the very abuse the FTC was intended to eliminate.

The FTC staff ultimately dismissed such concerns, arguing that the FDA always allowed a more colloquial version of technical terms in its label claims—"antitussive" could be rendered as "temporarily helps you cough less," for example—and that in any case manufacturers could petition the FDA for approval of new terms. The first of these contentions, while still offering a restriction on language, has some weight, even though it depended completely on the assumption that the FDA would act judiciously in the future (since the FTC rule was to cover products not yet reviewed by the FDA). The second contention, while accurate, offered little relief. The FDA program was (and is) an extraordinarily slow and expensive effort; alternative language could be proposed, but how long the FDA would take to decide would be anybody's guess.

Opponents of the rule also emphasized the informative purpose of advertising and tried to educate the FTC about contemporary thinking on the economics of consumer information. Testimony by economists portrayed advertising messages as primarily invitations to consumers to investigate further if they were interested in the product. Heavy technical language is not appropriate in such a context. Labeling language, on the other hand, was described as having a different purpose in this scheme: to allow the consumer whose interest has been aroused to gain precise technical information about a product and to compare one product with another. The permanence of labels also allows a consumer to review information at the time of possible use, when exact information is most important. The unrestricted use of truthful information is necessary, these witnesses asserted, if advertising is to be effective in reducing consumer search costs and increasing consumer benefits in the OTC drug market.

Economists arguing for the FTC view conceded that advertising is beneficial in some cases, but noted that it can also confuse and mislead consumers. They went on to suggest, without any particular empirical support, that OTC drug advertising was especially weak on this score. Industry witnesses countered that such deception is inimical to the self-interest of advertisers. Success in the OTC drug market depends on inducing repeat purchases of low-priced products, with advertising serving to inform the consumer of the product's existence and to get him or her to try it out. A customer who tries it and then feels cheated does not buy it again, does not buy the company's other products, and tells others about it to boot. Intelligent advertisers understand the importance of investment in reputation, even if the FTC does not.

After 1976, when the Supreme Court decided *Virginia State Board of Pharmacy* v. *Citizens Consumer Council,* opponents of the rule could invoke not only economic analysis but also constitutional doctrine. Before that decision commercial speech had generally been regarded as outside the protection of the First Amendment. In *Virginia Pharmacy* the Court made clear that commercial speech—advertising, to be exact—does have at least some constitutional protection. In the advertisers' view, this meant that the FTC could not suppress truthful claims whether or not they accorded with the FDA language.

Staff Recommendations

On May 22, 1979, the Bureau of Consumer Protection's staff made its final recommendation in the form of two versions of the rule—a first and a second choice. The staff was unpersuaded by all the arguments against the rule and continued to favor, as its first choice, the strict interpretation first presented in December 1975. The proposed rule said:

> In an ad for an OTC drug, you can make express or implied indication-for-use claims . . . only if the FDA . . . would allow you to make the same claims on the label of that drug. This means you cannot make claims the FDA has specifically disapproved. It also means that if the FDA only allows indication-for-use claims that use the specific terms it has approved, these are [the] only terms you can use to make indication-for-use claims in your ads.

Virginia Pharmacy did not affect the staff's opinion. The staff report emphasized that the Court's ruling had sought to protect only "truthful and legitimate commercial information," and had specifically endorsed the "elimi-

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nation of false and deceptive claims." This was thought to be enough to make *Virginia Pharmacy* irrelevant. In FTC practice, an ad need not actually deceive consumers to be deceptive; it is sufficient if, in the commission's expert opinion, the ad has a "tendency or capacity" to deceive. Since it would be difficult for anyone to show that an OTC drug advertising claim phrased in words other than those approved by the FDA conveyed exactly the same impression to consumers, any use of alternative words would have this tendency or capacity. In FDA logic, this made their use deceptive and thus outside the protection of the First Amendment, even if a particular claim was in fact true. Citing other case law, the staff went on to say that the proposed rule supported an "important or substantial governmental interest . . . unrelated to the suppression of free expression," which was that OTC drugs be safe and effective.

As its second choice rule, the staff recommended that if the commission were inclined to let the industry use words not approved for labels, it should at least require prior substantiation of claim terminology. The staff report set forth details of a statistical procedure for drug makers to use for this purpose.

Dissent from Within

Although a staff recommendation might be thought to reflect a consensus within the FTC, this turned out not to be the case. On December 15, 1980, a memorandum from the Bureau of Economics recommended against adopting a rule on the grounds that the benefits were speculative and the costs appreciable. The bureau's analysis discussed the differences in the economic function of labels and advertisements and then addressed the central controversy of the proceeding—restrictions on truthful advertising. "The cost of adopting staff's preferred rule," it said, "is that it will inevitably prohibit some truthful and useful information." For example, the FDA's proposed language for analgesics prohibited references to specific aches and pains, so that under the recommended FTC rule advertisers could not say that aspirin is good for muscle aches, a clearly truthful statement. The memorandum also noted the anticompetitive effects of forbidding firms to differentiate products by describing truthfully the benefits to be received by the user.

On the same day, the director of the Bureau of Consumer Protection (who supervises the rulemaking staff) weighed in with even stronger criticism, stressing several interesting points: (1) The record showed little, if any, evidence that OTC drug advertising had led to misuse or injury. (2) The FTC had intended that its proceeding would parallel the FDA's OTC drug review process. In fact, the FDA had completed a final monograph for only one class of drugs (antacids), so the FTC was in the position of developing rules for words that had not yet been defined by the FDA. This made it impossible to show that noncompliance with FDA language was widespread. (3) The staff's alternative recommendation that advertisers be allowed to convey claims to consumers in any manner so long as the words chosen communicated the same message to consumers as the FDA language gave inadequate guidance to both the advertisers and the commission. The bureau's director recommended that the proceeding be either suspended until the FDA finished its work or terminated without action.

The record showed little, if any, evidence that OTC drug advertising had led to misuse or injury.

The Last Hearing

Under the FTC's rules of practice for rulemaking, interested parties have one last opportunity to state their case in oral presentations to the assembled commissioners. The hearing on this proposal, held January 28, 1981, focused on the some questions that had been debated since the beginning, almost as if the entire long proceeding had never occurred.

The attorney for the industry spoke of the benefits to health care provided by OTC drugs, the lack of any evidence of deceptive practices in the industry's advertising, and the differing functions of label and advertising language. Commissioner Paul Rand Dixon seemed to agree: "It is kind of crazy for us right now to write any kind of rule, guessing what is going to be in FDA monograph No. 47." Commissioner Robert Pitofsky entered the discussion. "They say you should not describe a product as

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a cold remedy." But why not, he asked. "Products have been described as cold remedies as long as I can remember. Who is harmed when a product is described as a cold remedy when in fact it treats the symptoms but not the cold?" Pitofsky turned to an example to make his point:

> As I understand it, if we promulgated the preferred rule in the advertising campaign, "Give your cold to Contac" would be illegal, a violation of federal law. . . . I don't know the record on this, but I agree Contac is pretty good for colds. Why do we want to declare "Give your cold to Contac" to be fraudulent?

An attorney for a "public interest" group answered the question: The statement "is far too broad and led consumers to believe that Contac did something to cure colds. And it does not." The exchange ended with Pitofsky reminding him that labels, not thirty-second TV commercials, are the appropriate place for detailed discussion of cold remedies.

Fourteen days later, in announcing the final decision, Commissioner Pitofsky reiterated his basic point:

> I am not convinced that FDA determinations with regard to labeling claims are always or even usually appropriate for drug advertising. There is a danger that a rigid approach which ties advertising to government-approved words could restrict the dissemination of truthful and useful information.

The commission vote rejecting the rule was unanimous.

Some Final Thoughts

It is difficult to see the point of this long war. What did the five-year proceeding do that might not have been done (or that was not done) by the two dissenting memoranda and the brief hearing in the final days of the rulemaking? Surely the danger that the rule might suppress truthful information was as clear in 1975 as in 1981, especially after the staff had adopted its rigid interpretation. If the commission thought that interpretation pushed the rule too far, why did it not say so then? Similarly, if there was no evidence of consumer injury from OTC drug ads at the end of the proceeding, obviously there was none at the beginning. Why did the commission start and continue such a large enterprise if there was no particular reason to think there was a problem? Was it really necessary to build a record of over 13,000 pages, to bring in fifty expert witnesses, and to make everyone endure the cost of the struggle just to learn that truthful advertising should be allowed—especially when the rule's proponents could not even show that curbing it would produce any compensating benefit?

Was it really necessary to build a record of over 13,000 pages [and] bring in fifty experts . . . just to learn that truthful advertising should be allowed?

It may well be that the very elaborateness of the Magnuson-Moss process as adapted by the FTC makes it more difficult for the commission to recall a defective proceeding once it is under way. If regulatory reformers make Magnuson-Moss the general principle of all federal regulatory proceedings, their victory could be a Pyrrhic one indeed.

Even worse, it is by no means certain that the drug advertisers won anything more than a truce. A law suit that is terminated "with prejudice" cannot be brought again, but the termination of this proceeding carries no such guarantee. Here the FTC issued no comprehensive statement spelling out the lessons it drew from the proceeding and setting forth how it would apply them in the next one. One is left with the disturbing feeling that in 1975 the commission thought, based on staff recommendations, that the rule was a good idea, and that in 1981 the commission thought, based on policy problems apparent from the outset, that it was not. Interestingly, as a footnote that may reveal more about trends in opinion on regulation than about this decision, it is the second group of commissioners that seems the more liberal of the two. In any event, if the political climate or the composition of the commission changes yet again, FTC staffers could gain approval for another proposed rulemaking based on exactly the same theories and start down the long Magnuson-Moss track once more—in the hope that the second time around they would have their way. ■

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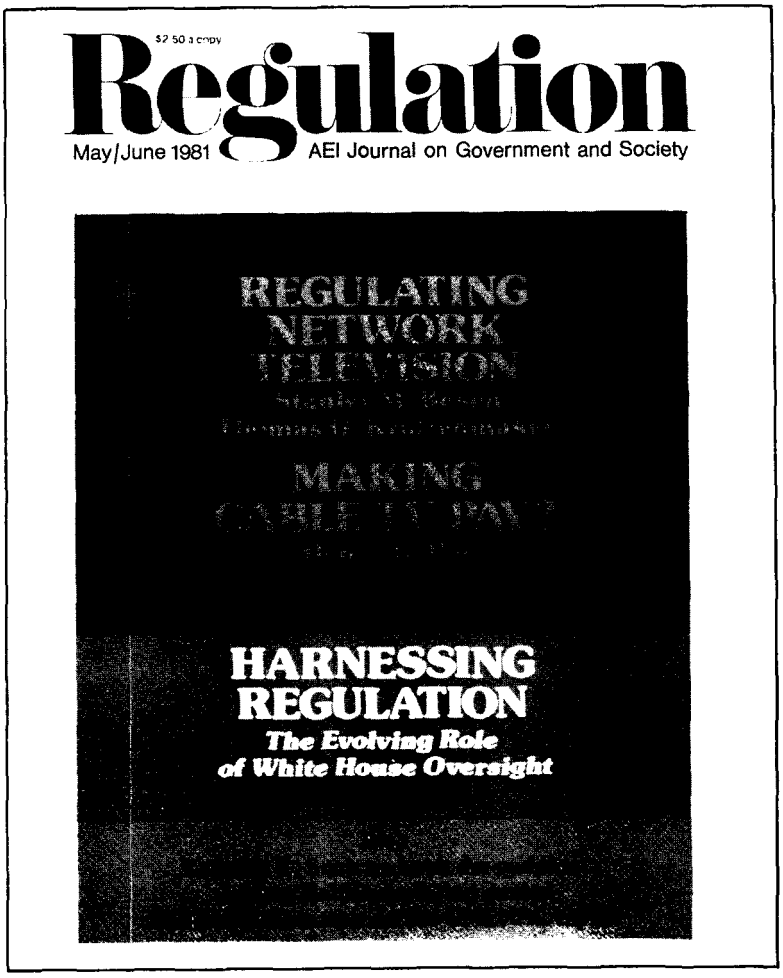

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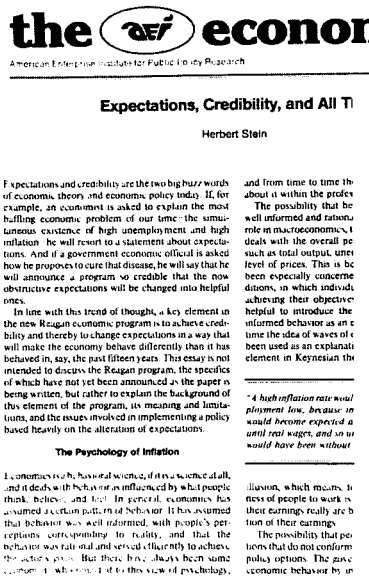
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Expectations, Credibility, and All Th
Herbert Stein
Expectations and credibility are the two big buzz words of economic theory and economic policy today. If, for example, an economist is asked to explain the most baffling economic problem of our time—the simultaneous existence of high unemployment and high inflation—he will resort to a statement about expectations. And if a government economic official is asked how he proposes to cure that disease, he will say that he will announce a program so credible that the now obstructive expectations will be changed into helpful ones.
In line with this trend of thought, a key element in the new Reagan economic program is to achieve credibility and thereby to change expectations in a way that will make the economy behave differently than it has behaved in, say, the past fifteen years. This essay is not intended to discuss the Reagan program, the specifics of which have not yet been announced as the paper is being written, but rather to explain the background of this element of the program, its meaning and limitations, and the issues involved in implementing a policy based heavily on the alteration of expectations.
The Psychology of Inflation
Economics is a behavioral science, if it is a science at all, and it deals with behavior as influenced by what people think, believe, and feel. In general, economics has assumed a certain pattern of behavior. It has assumed that behavior was well informed, with people's perceptions corresponding to reality, and that the behavior was rational and served efficiently to achieve the actor's goals. But there have always been some economists who objected to this view of psychology,
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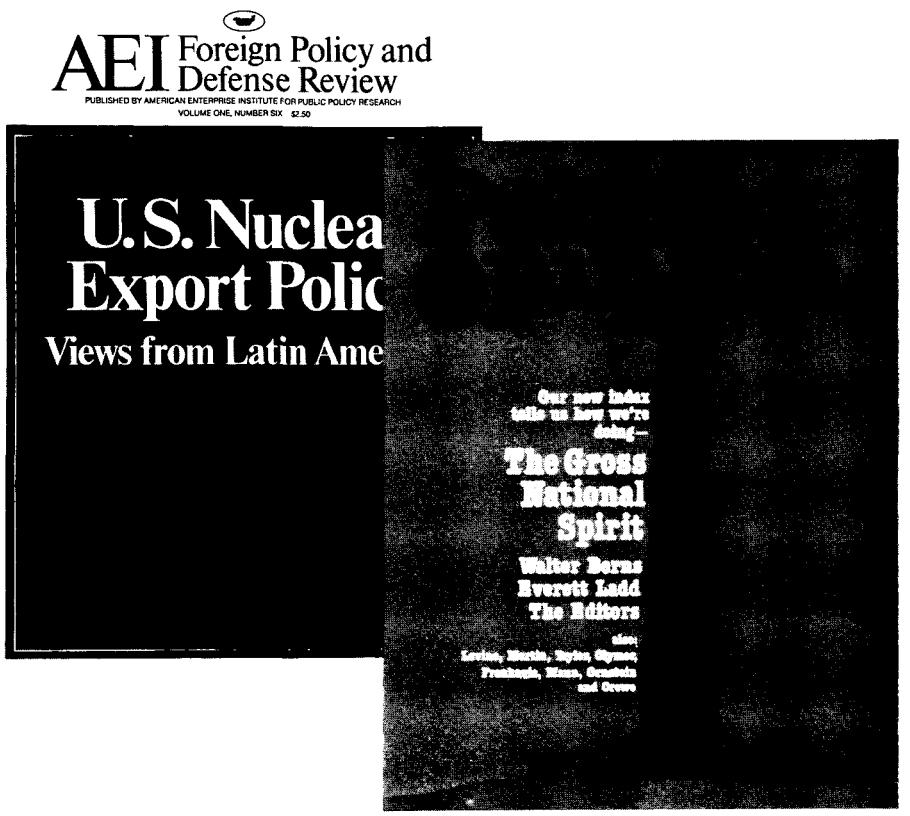
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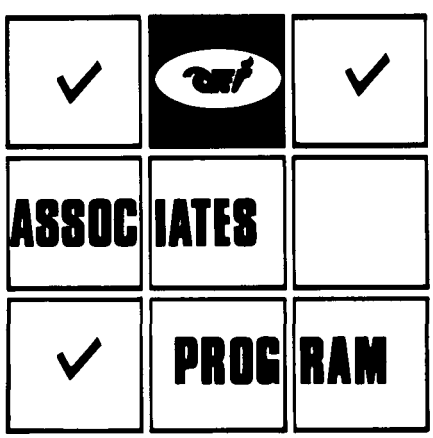

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Readings
of particular interest

The International Regulators

Regulating International Business through Codes of Conduct by Raymond J. Waldmann (American Enterprise Institute, 1980), 142 pp.

International codes of conduct for business, a relatively recent phenomenon, are becoming a focal point of conflicts between "North" and "South" on the world economic scene. Raymond Waldmann, a Washington attorney who is now assistant secretary of commerce for international economic policy, in this book examines some of the international regulatory codes that have been adopted already or are in the process of negotiation. While sympathetic to the principle of standardizing economic regulation across national boundaries, Waldmann says that the provisions of several codes should be of concern to the United States.

Treaties to regulate international commerce have long been common, in both bilateral and multilateral form. They have usually bound only governments, however, and affected private parties only indirectly. Where an international body monitored the agreement, it usually confined itself to informational and "housekeeping" functions.

The new type of code, Waldmann says, generally is intended to apply to the entire world, and increasingly regulates private bodies and transactions directly, instead of prescribing government treatment. The international body that enforces it has an independent existence of its own, and may have wide power to interpret the code's language, arbitrate and adjudicate conflicts, and cite private companies for violations. Its administrators are drawn from a burgeoning "economic diplomatic corps" stationed at international bodies in Geneva, New York, and elsewhere.

None of the codes has binding force within a country unless ratified by the country's government. Thus, the so-called Liner Code for ocean shipping adopted in 1974, one of the most ambitious codes of conduct, has yet to be ratified by any major maritime nation. This code would impose "cargo-sharing" rules, dividing most shipping trade between vessels of the buyer and seller nations, with only a small amount left to "third-flag carriers." In what Waldmann calls "a potentially far-reaching provision," the Liner Code also provides for mandatory binding conciliation of disputes, taking precedence over remedies available under national law. To go into effect, the code must be ratified by at least twenty-four states carrying at least 25 percent of total world tonnage; as of November 1978, thirty-three nations representing only about 6 percent of liner tonnage had ratified it. If the Liner Code does eventually go into effect, Waldmann notes, the United States will be affected whether or not it is one of the ratifiers, since U.S. ships often serve as third-flag carriers between foreign ports.

More far-reaching in implication are the ongoing negotiations for a Code of Conduct on the Transfer of Technology. In 1975, member governments of the United Nations Conference on Trade and Development (UNCTAD) began work on such a code, with rival drafts submitted by developed and less developed groups of countries. A working group has been meeting periodically since 1977 trying to iron out differences between the two sides.

Several Latin American countries, along with Spain and Portugal, have for some years controlled technology transfers from abroad. The Andean Common Market code, which may offer a preview of the international effort, seeks to prevent foreign firms from placing conditions on the export of their technology. Among the conditions prohibited in contracts for technology transfer, Waldmann says, are clauses that limit the volume of production, require the recipient to buy raw materials or technologies from specific sources, require the re-

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cipient to transfer further improvements or inventions to the technology supplier, or allow the supplier to fix the sales price of products manufactured using the technology. A Mexican law similarly attempts to screen out "dependency-creating" investments, and both Mexico and Brazil prohibit contracts that limit a recipient's right to export products using the transferred technology. Portugal's code particularly restricts transactions between foreign firms and their branches in Portugal.

The draft code prepared by the less developed countries for UNCTAD's consideration included "a long list of provisions that must be guaranteed by the suppliers of the technology," among them that the technology be "suitable" and "appropriate," that local input and consultants be employed and local personnel trained to use the technology, that the recipient have access to all improvements, and that the payment for the transfer not exceed "market prices." UNCTAD has also suggested the establishment of national and regional centers for the transfer of technology, which Waldmann says would "identify technological needs; collect, store, and distribute information on alternative technologies; and evaluate and select appropriate technologies for the needs of each developing country."

The overall theme of the less developed countries' demands is that technology must be "sold," not "rented." Waldmann warns that this idea might make the owners of intellectual property unwilling to sell their knowledge overseas, especially at officially set prices, and that less developed countries might therefore never get the technology they desire at all. Most hazardous of all, he says, would be the overturning of existing contractual arrangements, especially between parent firms and their foreign subsidiaries.

In 1973 the United Nations Secretariat proposed an even more sweeping system of regulation—an international code of conduct for multinational corporations. The UN Economic and Social Council established a commission in December 1974 to come up with such a code, and a UN Center on Transnational Corporations began to operate in November of the next year to provide research and other support. While these groups have not reached any final conclusions, they have produced annotated outlines of code provisions which indicate the drift of the negotiations. One outline calls for multinationals to abstain "from requesting their home governments to exert pressure on host governments beyond normal diplomatic representation"—putting the code, Waldmann says, "clearly on the side of expropriating countries in their continuing contest with expropriated companies." Another working group is addressing the question of corrupt practices; participants differ as to whether the problem should be addressed through an international agreement or through unilateral action by nations. (See Perspectives, p. 11.)

While expressing some reservations, the U.S. government has repeatedly backed the concept of international codes of conduct. Secretary of State Kissinger, at the fourth UNCTAD session in Nairobi in 1976, gave what Waldmann calls "full but general support" to technology transfer initiatives, without going into details. The United States has also endorsed mandatory sanctions against corrupt practices, breaking ranks with other developed countries on the general issue of whether code application should be voluntary. Waldmann notes that the United States has also lent its support to a related type of international activism—the so-called Common Fund, a mechanism to set the international levels of commodity prices.

Incentives in European Water Pollution Control

Incentives in Water Quality Management: France and the Ruhr Area by Blair R. Bower, Remi Barre, Jochen Kühner, and Clifford S. Russell (Resources for the Future, 1981), 302 pp.

In France and the industrial Ruhr valley of West Germany, water polluters pay effluent charges based on the amount and type of pollution they emit. Economists have sometimes cited these arrangements as instances of incentive-based standards, contrasting them with command-and-control standards specifying the exact discharge treatment processes polluters must adopt. The latter are said to characterize U.S. pollution control.

The authors of this report (Bower and Russell of Resources for the Future, Barre, of a French consulting firm, and Kühner, an inde-

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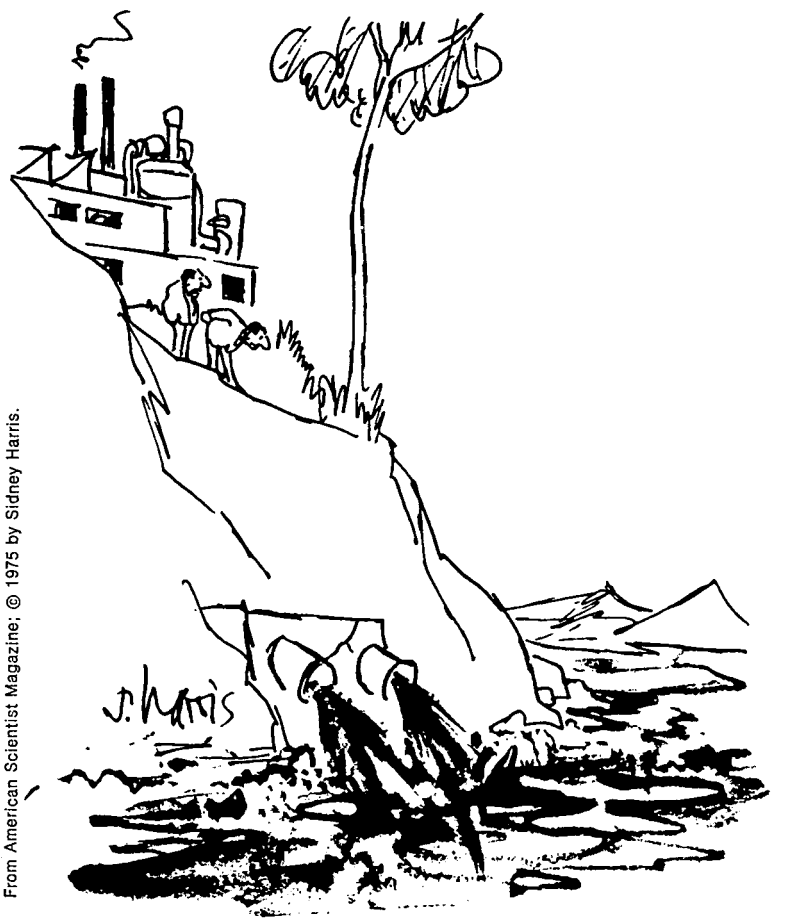
pendent consultant) survey the two European systems in some detail, and conclude that such a view may be unwarranted for three reasons. First, the European and indeed the U.S. systems of water pollution control are a blend of incentive and command elements. Second, while the European systems appear to work well, there is not sufficient data to decide whether they work better than ours—or, if so, whether the incentive elements make the difference. Finally, the authors note, in the two systems analyzed effluent charges are set at levels reflecting not the criteria favored by economists (such as the marginal damage done by pollution) but simply the revenue needed to fund pollution control efforts.

At the heart of both the French and the German systems are discharge standards embodied in permits. Subsidies are available for constructing treatment plants (and for making some in-plant process changes) and, in the French system, for rewarding a plant's subsequent performance in pollution reduction. To a significant extent these subsidies are financed by the effluent charges. And since the program of subsidies must be mapped out with fair certainty for several years at a time, the level of the charges is set to provide sufficient revenue to fund the anticipated subsidies (plus, where applicable, the other environmental actions and the administrative costs of the responsible agency). Thus the charges applying to individual activities are set at levels meant not to approximate marginal damages, to stimulate certain degrees of treatment, or to produce a specified improvement in water quality, but purely to raise a given amount of revenue.

Toward this end, the projected revenue needs of the agency are apportioned over projected discharges in order to calculate a charge per unit of emission. The most easily explained method is that used in the Ruhr area, where an index (often referred to as a "population equivalent") combines several key measures of pollution (biochemical oxygen demand, suspended solids, dissolved solids, and toxic substances), and polluters must pay a set fee for each index-unit they emit. Under the French system the agency's projected costs are divided among the major pollutant categories (biochemical oxygen demand, suspended solids, salts, and toxics), and unit charges on each are based on the anticipated emissions in those categories. These anticipated discharges were originally based on rules of thumb for all pollution sources of a particular type, such as breweries or tanneries, but are increasingly based on periodic sampling of discharge. However, Russell and Bower note,

> sources that believe their waste streams to be cleaner than allowed for in the rule of thumb can demand individual sampling (paid for by the charging authority or by



From American Scientist Magazine; © 1975 by Sidney Harris.

"What's the difference? It was a man-made lake in the first place."

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the source, depending on outcome of the measurement); but those activities doing worse than implied by the rule of thumb pay only the rule of thumb charge and are only in trouble if they violate (and are caught violating) the terms of their permits.

Because most of the fees are plowed back into subsidies for waste treatment, Russell and Bower observe, "the sources in the region end up in aggregate about where they would be without either charge or subsidies but with only their permit requirements to meet." Particular sources, of course, can fare better or worse financially than this average. French municipal waste treatment plants, for example, receive subsidies but do not pay effluent charges, which are instead collected through the largely private water supply companies.

Another key to the program's political success in France "appears to have been the very gradual raising of charges to operational levels. The initial charges were essentially trivial and thus sources had a chance to get used to the mechanism before the payment could even be felt." Over time, the real charge levels continue to grow as population and industrial growth require greater and greater treatment efforts to prevent pollution levels from rising.

The book notes in passing that in 1976 West Germany enacted a law that does impose charges in line with one of the models favored by advocates of incentive systems. But as the imposition of charges does not begin until 1981, there is as yet no experience with this law.

When the Public Servant Gets Sued

"Suing Our Servants: The Court, Congress, and the Liability of Public Officials for Damages" by Peter H. Schuck, in *The Supreme Court Review*, vol. 1980, pp. 281-368.

One of the most remarkable developments in public law doctrine during the last decade has been the dramatic expansion of the liability of individual public officials—federal, state, and local—for money damages. The Supreme Court's decisions since 1978 have had the overwhelming effect of enlarging the liability of officials and governmental units and narrowing the immunity of governmental units and of most officials. In this article Professor Peter Schuck of the Yale Law School probes the likely implications of this change.

Beginning with the proposition that to pose the question of the appropriate scope of official liability "is one way to ask how we wish to govern ourselves," Schuck speculates on the possibility that "a remedy designed to compensate victims and deter official illegality might in fact defeat some important social objectives and ignore others. Such a remedy might spawn new injustices less visible and thus less tractable."

The author contends that rules governing official liability can be evaluated by the extent to which they advance a number of social objectives: compensating victims of official illegality; deterring officials from engaging in misconduct; encouraging them to execute their duties in a decisive, selfless, and socially beneficial manner; shifting losses from individuals to larger social groups; reinforcing community norms concerning the morality of certain behavior; equity; and avoiding perverse redistributions of wealth. While these objectives almost always conflict to some degree, Schuck points out, the dominant tendencies of tort law, administrative law, and constitutional law have converged in recent decades in ways that strongly encourage courts to expand official liability. Thus, contemporary tort law emphasizes compensation, loss-spreading, and deterrence, even where they conflict with the goals of morality and vigorous decision making. Modern administrative law has legitimated and expanded judicial influence over the exercise of bureaucratic discretion. Constitutional law confirms and encourages two shifts of power—first, from state and local officials to federal officials, especially federal judges; and second, at the federal level, from Congress to the agencies and judiciary.

Schuck then attempts to predict the behavioral consequences of legal rules that increase the exposure of public officials to personal liability for damages. He focuses on what have been called "street-level bureaucrats"—policemen and other law enforcement personnel, school teachers and school board members, social workers, administrators of mental hospitals, inspectors, parole officers, prison officials, and the like. Drawing upon published empirical studies, he examines the distinctive

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nature of their working environment, including their interactions with members of the public, their official goals and duties, the risk that they will harm others, the scope of their official discretion, the kinds of incentives they face when making a decision, and their political, institutional, and resource constraints. Facing the prospect of personal liability, Schuck argues, such an official "has an unusually strong incentive to minimize the costs to him of a particular course of action" (at least within what Schuck calls his "duty constraint") even if this does not maximize social benefits; "indeed, in the extreme case he would be willing to forgo all such benefits so long as he could thereby reduce even slightly the costs to him of a given decision." Moreover, the street-level official has "ample scope" to engage in self-protective behavior in ways that escape detection or effective control. These stratagems can include inaction, delay, and excessive formalism, as well as changes in the character of the eventual decision.

The author emphasizes that, for several reasons, we cannot be certain how often and to what social effect officials employ these self-protective devices. For example, officials have other reasons besides fear of liability for using these devices; moreover, the victims of such behavior are usually unaware either that they are being injured or that their injury has been caused by some official's personal risk-minimizing strategy. Schuck concludes, however, that the extent of self-protective official behavior is probably both substantial and increasing.

Next, Schuck considers whether giving most street-level officials a qualified "good faith" immunity is sufficient to discourage this kind of self-protective behavior. After reviewing the way in which courts have actually treated the immunity issue, he concludes that "the qualified, 'good faith' immunity standard, far from assuring an official that vigorous decisionmaking will be rewarded, is pregnant with risk to him: a rather small risk that he will ultimately be held liable, a somewhat higher risk that the immunity will ultimately be denied"—whether or not he is found liable in the case at hand—"and a substantial risk that a full-dress trial will be necessary to establish its applicability and scope." Schuck says that while the government can assume some of its officials' risks by providing them with free defense counsel, purchasing liability insurance for them, and indemnifying them for any claims, these measures do not suffice to eliminate all serious risk to officials. The result of these risk-shifting arrangements may be the worst of all worlds: encouraging self-protective official behavior, denying valid claims, and where government is immune, denying victims of official illegality an adequate remedy against insolvent defendants.

In the final section, the author contends that the existing system of official liability fails to achieve the intended degree of compensation, deterrence, and other social objectives. He maintains that a superior system would integrate three elements—a substantial expansion of governmental liability (especially at the state level), a contraction of official liability, and a strengthening of systems of administrative control of employee misconduct. Schuck then discusses how such a system might be designed. He concludes by considering a paradoxical relationship between the official liability remedy and the values it seeks to secure: in the world of the street-level official, a more powerful remedy may in the end achieve less of those values.

A Policy Built on Shifting Sands?

"Bureaucracy, Entrepreneurship and Natural Resources: Witless Policy and the Barrier Islands" by William J. Siffin, in *Cato Journal*, vol. 1, no. 1 (Spring 1981), pp. 293-311.

The 300 barrier islands on the Atlantic seacoast, stretching from Cape Cod to the Mexican border, form the most elaborate chain of this kind in the world. They range from small elevated sandbars to islands of more than 100,000 acres, and contain such cities as Miami Beach, Atlantic City, and Galveston. Their exposed position puts them in the direct path of devastating storms: in the past eighty years, according to the National Hurricane Center, some 12,000 persons have been killed and about $13 billion in property has been destroyed by storms sweeping inland across barrier islands.

According to William Siffin, professor of political science and public and environmental affairs at Indiana University, several federal

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policies indirectly promote the development of barrier islands, placing lives and property at needless risk and diverting resources away from potentially more productive investments. The most important of these policies is the federal flood insurance program, which subsidizes property loss risks in flood-prone areas. The program has nominal control over the building standards of the properties it insures, and it can encourage local communities to institute land-use controls in flood plains—both of which powers are intended to keep casualty losses down. But since the rates for the riskiest areas are set far below what would be actuarially sound, the program is expected to pay out much more to barrier island property owners than it gets back from them in premiums.

South Padre Island, Texas, is one such vulnerable island. In 1967, Hurricane Beulah rendered more than 90 percent of its dwellings uninhabitable. By 1978, Siffin writes, the federal government had written flood insurance for South Padre and neighboring Port Aransas, with a combined permanent population of 2,000, amounting to $464 million.

"Insurance makes all the difference in the world in a place this prone to hurricane damage," South Padre's mayor reportedly said. "The boom began in 1971 when we started getting mortgage money." Federal insurance administrator Gloria Jimenez estimated in 1980 that an actuarially sound insurance program might require premiums of as much as $14,000 a year on private residences. If Congress ever cuts off the subsidy, she said, "the uproar will be horrendous."

Settlement of the islands is also encouraged by disaster relief programs. After Hurricane Frederick did extensive damage to the Alabama-Mississippi coast in 1979, for instance, the Army Corps of Engineers spent $80 million cleaning up debris, and the Small Business Administration's disaster loan fund disbursed $50 million in less than a year to help local businesses rebuild. The Federal Emergency Management Agency likewise provides a range of grants and services to storm-struck localities. At the same time, agencies like the Army Corps of Engineers and the Commerce Department's Office of Coastal Zone Management finance hurricane protection projects and the development of state regulations designed to guard against the storm damage.

Federally financed public works are another important spur to barrier island development, according to the author. Foremost among these are roads and bridges. After Hurricane Frederick destroyed a bridge linking Dauphin Island (population 1,200) to the Alabama mainland, the Federal Highway Administration authorized $33 million to build a new bridge. The total market value of the island without the bridge, Siffin says, was only about $7 million.

The Corps of Engineers dredges harbors and navigation channels, replenishes beaches, and attempts to stabilize shorelines against erosion. Because shoreline erosion is a natural process on the sandy islands, Siffin warns that such stabilization may be at best a palliative. Environmental Protection Agency grants fund much of the expense of waste-water treatment plants and sewers for the islands, and the Office of Coastal Zone Management, the Economic Development Administration, and the Farmers Home Administration finance a variety of other public improvements.

Taken as a whole, Siffin argues, these programs constitute an "unintended system" that shifts much of the costs of barrier island development from local landowners to the general public, with the predictable result that these costs are incurred in unreasonable measure. In the absence of a shift in federal policy, Siffin predicts, the urbanization of the islands will proceed at a rapid clip.

Rent Control: From Amid the Rubble

Rent Control: Myths and Realities, edited by Walter Block and Edgar Olsen (Vancouver: Fraser Institute, 1981), 335 pp.

Both Canada and the United States have seen a revival of interest in rent control in the past decade. In this book, economists Walter Block of the Vancouver-based Fraser Institute and Edgar Olsen of the University of Virginia assemble new and old essays on the theory and practice of rent restriction.

That rent control should have spread in the late 1970s is in a way paradoxical, argues Ted Dienstfrey of the California Housing Coun-

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cil, because rents rose less rapidly in that decade than consumer prices and much less rapidly than the cost of home ownership: from a 1967 base, rents were up 78 percent in mid-1979, consumer prices 121 percent, and home ownership costs 168 percent. Dienstfrey also notes that public attitudes on the issue are highly ambivalent. A California Field poll taken a year after Proposition 13 found that 73 percent of tenants believed their own rents to be fair, but that 81 percent believed that rents in general were unfair. (See Viewpoint, page 13.)

New York City's experience with rent control is the best known. In 1940, Olsen writes, before rent control, the vacancy rate in New York City, for owned and rented property taken together, was actually higher than in other cities—7.3 percent versus 4.7 percent. In 1950, with almost all cities under federal rent controls, the comparable figures were 1.1 percent for New York City and 1.4 percent for other cities. By 1960, when almost all cities other than New York had lifted controls, the figures were 2.0 percent and 4.0 percent.

Several essays document the decline in housing quality that has accompanied New York City's housing shortage. Thirty-four percent of the city's controlled apartments suffered heating system breakdowns, according to a Census Bureau survey cited by Frank Kristof of the Rent Stabilization Association. By contrast, the survey found heating breakdowns in only 13 percent of the city's decontrolled units of similar age, and in only 20 percent of apartments of similar age in northeastern central cities generally. Thirty percent of the controlled units had holes in the walls or ceilings, compared with 16 percent for uncontrolled units and 19 percent for apartments in northeastern cities. Overall, according to a 1977 HUD report, rent control has reduced the New York City tax base by an estimated $1.5 billion, costing the city government $115 million annually in tax losses.

Bertrand de Jouvenel and F. W. Paish, in essays from the late 1940s, recount far more drastic examples of rent restriction in France and England respectively, which have both had controls since World War I. In France, the maximum allowable rent was set in 1947 at 6.8 times the 1914 rent, even though retail prices were 99.8 times higher than in 1914. "A dollar a month will pay a wage-earner's rent in Paris," de Jouvenel says, speaking of the situation soon after the 1947 edict. "To put it another way, a month's rent for an individual worker costs little more than six packets of the cheapest cigarettes." The only ways to obtain a vacant apartment (vacated, generally, through the death of the previous tenant) were to get a government requisition or pay the owner a bribe of $500 to $1,500 per room.

Although England did not suffer as severe an inflation as France, rents there still lagged far behind increases in the price level, according to Paish. In some cases rents could be changed only when the units became vacant: "If a house was last let in 1815, then the rent paid at the time of the battle of Waterloo is the standard rent today." A recent study indicates that the percentage of English households living in privately rented housing has fallen from 61 percent to below 15 percent over the more than sixty years of controls, according to contributor Richard Ault of Louisiana State University. F. G. Pennance of the University of Aberdeen notes that by 1970 the only free sector of the housing market, furnished lodgings, was also the only sector where supply was increasing. In 1974 a Labor government brought furnished units under controls as well.

Among other essays collected in the volume are Milton Friedman and George Stigler's 1946 *Roofs or Ceilings?* and a 1930 lecture by Friedrich von Hayek drawing on Vienna's experience with controls. The "fossilization" of housing patterns in that city, Hayek argues, kept workers from finding residences close to their jobs and thus increased their demand for transit: "The cause of Vienna's increased tram traffic, which doubled between 1913 and 1928 at a time of diminishing population, can only have been this inhibited mobility."

Block, Olsen, and Fraser Institute director M. A. Walker take up the question of how decontrol can best be achieved. Decontrolling vacant apartments, often advanced as a relatively painless way out, has at least one major drawback, Walker says: there is no reason for investors to believe a government's promises. New York City, as Dienstfrey and Kristof observe, made such a promise in 1947, only to renege on it in 1969. Olsen and Walker propose phasing out controls gradually, with a specific termination date set for the future; immediate decontrol, they maintain, would be too risky

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politically. Block, however, holds that gradual decontrol frustrates natural processes of adjustment and postpones the emergence of proper incentives for investors and developers.

Several contributors quote Swedish socialist economist Assar Lindbeck's remark: "Next to bombing, rent control seems in many cases to be the most efficient technique so far known for destroying cities." The book provides some graphic illustrations. At the start of each chapter is a photograph of a devastated, rubble-strewn urban scene; at the back of the book is a list of which photos are of cities with rent control and which are of bombed-out cities in wartime.

Regulation and Mine Safety: The Statistical Link

"Can Government Regulate Safety? The Coal Mine Example" by Michael S. Lewis-Beck and John R. Alford, in *American Political Science Review*, vol. 74 (September 1980), pp. 745-755.

A coal miner working in 1932 was more than four times as likely to be killed on the job as one working in 1976. In the intervening forty-four years Congress passed three major laws increasing federal regulation of mine safety—in 1941, 1952, and 1969. This article, by Michael Lewis-Beck of the University of Iowa and John Alford of Oakland University, investigates the extent to which the three laws contributed to the improvement in safety. It concludes that the 1941 and 1969 laws significantly reduced the death rate in coal mining, while the 1952 law did not and in fact stopped the ongoing decline in death rates.

Lewis-Beck and Alford begin with a look at the broader debate over the effectiveness of safety regulation. They group the participants in the debate into three categories, which they label "radical," "reformist" and "reactionary." The first and third groups share, for entirely different reasons, the view that mine safety regulation must be ineffective, the authors say. The "radicals" hold that it is at most symbolic, a way to salve the public conscience until the next big mine disaster, and that the interests of mine owners inevitably prevent any real change. The "reactionaries" hold that rules and regulations cannot control human error, and that the carelessness of miners and the inherent dangers of coal mining will cause about the same number of accidents no matter what the regulators do. The last group, the "reformers," believes that regulation can bring about safer conditions.

To isolate the effects of the mine safety laws, the authors carried out a statistical analysis of the data for annual fatalities per million man-hours from 1932 through 1976. They used a regression equation with variables representing changes in mining technology, the size of mines, and the ratio of deep mining to surface mining. (It was important to allow for the effect of these variables since small mines are riskier than large ones, and deep mines riskier than surface ones.) Three other variables represented the influence of the 1941, 1952, and 1969 laws.

During the 1930s, they found, the fatality rate drifted with no evidence of a declining trend. Then, after the 1941 law was passed, the death rate went into a decade-long decline during which a coal miner's chance of dying on the job was cut by about one-third. This trend was arrested around 1952, at about the time the second law was passed, and for nearly two decades the death rate again showed no signs of improvement. Finally, in the early 1970s, it began a sharp drop that continued to 1976, the end of the period studied.

The author's regression analysis came up with strong negative correlations between the death rate trend and the passage of the 1941 and 1969 laws, and an almost equally strong positive correlation between the trend and the passage of the 1952 law. What characteristics of each law could account for these effects? The 1941 law gave federal inspectors the right to enter the mines; their safety recommendations, however, were not binding. Lewis-Beck and Alford speculate that the inspectors' mere presence may have led operators to take some simple and cheap safety steps. The 1952 law gave the Bureau of Mines the power to enforce safety measures aimed at preventing "major disasters," but these accounted for less than 10 percent of all fatalities. Furthermore, because the legislation did not apply to mines employing fewer than fifteen miners, it covered only about a fifth of all mines. According to the authors, all parties concerned showed a lack of

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interest in enforcing the 1952 law—even the United Mine Workers, which ceased to have an adversary relationship with management after 1952. The 1969 law was a "tough" one, they say, and established a detailed set of health and safety standards. It was also costly: by one estimate it was largely responsible for a rise of 10 percent a year in the cost of eastern deep mining, and by another estimate it contributed to a drop in output of more than 30 percent per miner.

Another variable that may explain the success of safety legislation is its intensity of enforcement. The authors charted the rise in the health and safety budget of the Bureau of Mines (later the Mining Enforcement and Safety Administration), and found that it had a significant correlation with the degree of safety in the mines. The budget figures were stable through the 1930s, jumped sharply in 1942 and continued to rise for ten years, increased very slowly from 1952 to 1969, more than doubled from 1969 to 1970, and continued rising thereafter.

These results, the authors note, do not entirely vindicate any of the three schools of regulatory thought. The apparent success of the 1941 and 1969 laws should confound the "radical" and "reactionary" critiques; but the apparent failure of the 1952 law should give pause to the "reformer."

Environmental Hazards and the Sensitive Individual

"Sensitive Populations and Environmental Standards" by Robert D. Friedman (Conservation Foundation, 1981), 54 pp.

The Environmental Protection Agency and the Occupational Safety and Health Administration, in fixing permissible levels for pollutants and other health hazards, have from the first sought to protect particularly sensitive individuals, such as asthmatics and the elderly. Both agencies interpret the law as requiring such protection, although neither the Clean Air Act nor the Occupational Safety and Health Act speaks in so many words of such sensitive populations.

Robert Friedman, currently a staff attorney at the Federal Trade Commission, maintains that the agencies' interpretation is reasonable. Using this premise as a jumping-off point, he explores the legal and policy implications of such protection.

Friedman first focuses on EPA's latest ambient air standards for lead and ozone, issued under the Clean Air Act. While EPA must attempt to protect the "most sensitive" in setting a standard, he argues, the definition of that term is essentially arbitrary. In the case of lead, for example, more and more sensitive subsets of the population can always be identified, so that ultimately there is no level of lead in the ambient air that could be considered "safe." Thus, Friedman argues, the identification of a most sensitive population is, in reality, one way for EPA to make a policy decision as to the degree of protection it will require. Neither the language nor the legislative history of the Clean Air Act provides EPA with much guidance on how to make that decision, since considerations other than health (such as cost or technological feasibility) are specifically held to be irrelevant in setting national ambient air quality standards.

The author notes that the Clean Air Act incorporates the concept of "threshold" levels of pollutants below which there are no adverse health effects, and requires EPA to set standards with a margin of safety below the threshold. But science, he says, has been unable to fix such thresholds, especially for particularly sensitive groups. If the threshold concept is tenuous in the case of such groups, the idea of a margin of safety below the threshold is equally tenuous. Without a scientifically definable threshold, decision makers are again forced to fall back on their own judgment, and the resulting standards will not be based strictly on some identifiable quantum of exposure that must be avoided for the protection of health.

Of particular interest to the author is the question of regulating hazardous pollutants. Here, again, EPA is charged with considering only health when setting standards. The issue of sensitive populations has not yet become critical because almost all hazardous pollutants regulated so far have been carcinogens, for which scientists have been unable to identify safe thresholds for *any* individual (thus making moot any consideration of sensitive populations). According to Friedman, EPA faces a

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quandary: it must reconcile its mandate to look only at what is necessary to protect health with the realization that for carcinogens only a zero emissions level is thought to be entirely without risk.

Turning to OSHA, the author notes that the language, legislative history, and judicial interpretation of the Occupational Safety and Health Act over the years all point to an obligation to protect sensitive populations, even though the act makes no specific reference to the issue. This has led to controversy in the development of OSHA standards for cotton dust and lead. Nevertheless, OSHA's dilemma is much less acute than EPA's because OSHA's authority is statutorily limited by the requirement that its standards be feasible. Congress has thus implicitly recognized that it may not be technologically or economically feasible to protect all workers from all risk. In both the cotton dust and lead standard, the author says, OSHA accordingly attempted to set exposure levels as low as was feasible, acknowledging that many workers in the most sensitive group would still not be protected.

Of course, as Friedman points out, feasibility itself is not a hard-and-fast concept, but will depend to some extent on an evaluation of the health risks involved in any given case. At some point in the standard-setting process, it might not be considered "feasible" to achieve an insignificant incremental health benefit, however measured, in light of the costs to be imposed. It is the courts that have had to wrestle, so far, with what "feasibility" means in the context of particular regulations.

One other course of action, open to OSHA but not to EPA, is to allow employers to monitor workers and remove susceptible individuals from the site of the hazard when their vulnerability becomes apparent. Although such medical surveillance may not be of use in the case of carcinogens, it is an important tool in both the cotton dust and lead cases, Friedman says.

The author concludes that as our techniques for identifying ever more sensitive populations become more refined, the concepts of thresholds and margins of safety become increasingly "archaic." The result will be to call into question, in more and more regulatory decisions, society's ability and willingness to provide environments that protect such groups.

Overseas Ethics, Four Years Later

(Continued from page 12)

on the other hand, has objected to publishing interpretations and guidelines, and has only reluctantly and temporarily agreed not to prosecute firms that follow the official Justice guidelines. Even if the two agencies cooperate, SEC registrants will likely face different enforcement rules than nonregistrants.

For all of the above reasons, work is proceeding on Capitol Hill to revise some of the statute's more controversial provisions. Senator John Chafee (Republican, Rhode Island) has introduced S.708, which would add a "materiality" requirement to the accounting section, eliminate the "reason to know" standard of responsibility for an agent's acts, require increased compliance guidance by the Justice Department, and transfer civil jurisdiction over the bribery provisions from the SEC to Justice. Chafee's bill would also legalize payments that were legal in the country in which they were made. The Reagan administration has gone further, urging full repeal of the accounting provisions and the SEC's enforcement role. Knowing falsification of accounting records to facilitate corruption would remain illegal under both the proposals.

As one possible way of restoring their competitiveness, many businesses have called for an international antibribery pact. Negotiations have been proceeding for years in the United Nations on this subject, with agreement nowhere in sight. (See Readings, p. 50.) The seven industrialized countries that met at the 1980 Venice economic summit agreed to work toward a multilateral pact of their own, but again there is no prospect that it will ever be completed.

Some proponents of the act assert that retaining it will give the United States a consistent position when it argues for an international pact; some opponents fear that the other industrialized nations will find it worth their while to perpetuate their current competitive advantage by stalling at the talks. One might wonder whether American business's current enthusiasm for an international pact, if indeed it does arise entirely from competitive motives, would evaporate if this country were to repeal its law.

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(Continued from page 3)

The principal difference between controlled trading and marketable permits is that in the former system tradeable assets are created by reductions below an existing baseline rather than by allocations from a zero base. This avoids allocation problems, while capturing most of the cost savings of a permits approach, and it neither forces all firms to trade nor requires existing systems to be restructured across-the-board before trading can start. If this approach can work for heavily regulated air pollutants for which the location of emissions matters, it can work for CFCs, for which location is irrelevant and no regulatory structure currently exists.

Michael H. Levin,
Regulatory Reform Staff,
Environmental Protection Agency

TO THE EDITOR:

. . . Rabin worked at EPA last year while the agency prepared the advance notice of its intent to regulate. His article is simply a rewriting of that agency document. He seems less concerned with the science of the ozone issue than with getting on to a new regulatory device, and avers that "the scientific debate is too technical to pursue in detail here." But your readers deserve to know more of the story.

The National Academy of Sciences, using computer models, concluded two years ago that a 16.5 percent depletion of stratospheric ozone could result from continued CFC emissions at 1977 production levels. More recent government- and industry-supported research, however, has revised the NAS estimates downward dramatically. Studies from Britain and the European Economic Community contradict the NAS report and recommend further research. Actual monitoring has shown an *increase* in ozone levels, not a decrease.

In short, there is serious doubt about the theory linking ozone depletion to CFCs. Rabin dismisses this scientific uncertainty. CFCs have many essential applications in air conditioning, food preservation, insulation, medical care, and elsewhere; before we abandon their benefits, we should prove or disprove the theory. Research is under way to achieve this. (Senator Bentsen and Representative Luken, among others, have introduced legislation to delay any EPA move on CFC production until sound evidence exists to warrant it.)

Rabin leaves many questions unanswered: How would a cap alter market responses? Would scarce supplies actually flow to the "highest and best" uses or to those with the ability to pay? Would monopolies arise? Could small companies, which need an adequate product supply to survive, still compete? Once the marketable permits game has begun, would competition from new producers be allowed? How would research and development and the capital investment programs of CFC producers be affected? Would any substitute be as safe, as cost-effective, as beneficial, as desirable to the worker *and* the consumer? Is there really a justification for regulation that would affect:

- more than 5,000 direct business users of CFCs, most of them small?
- nearly a quarter million business locations which rely on CFCs?
- more than three-quarters of a million related jobs?
- some $135 billion worth of installed products touching virtually every consumer?

Note that these are all domestic disruptions. In the rest of the world, CFC production would proceed unregulated. The ozone issue is global, but EPA controls affect only American business.

Rabin's "maiden venture" into uncharted waters of government regulation would profoundly disrupt the American marketplace. We recommend against it.

Melvin C. Holm,
Chairman, Alliance for
Responsible CFC Policy

ROBERT RABIN responds:

Levin expands on a point that I made in passing; namely, that a marketable permits system for chlorofluorocarbons is one of a number of economic incentive strategies developed by EPA in recent years. I would hope that the new administration will evaluate these initiatives on their merits, rather than assuming that anything inherited from the previous agency leadership must be tainted. Levin's update provides some cause for optimism. I would offer only two brief qualifications to his remarks. First, I am not convinced that the offset and banking policies he mentions establish the "critical groundwork" for CFC marketable permits. Traditionally, CFC use has not been regulated and any market that is established will have very different characteristics from the air pollution control system. Thus, the ground remains to be broken; and as Holm's letter indicates, the vested interests will make their voices heard. Second, I disagree with the statement that allocating CFCs from a zero base rather than reducing emissions below an existing baseline is necessarily "a principal difference" between marketable permits and controlled trading. If CFCs are allocated according to some percentage of historical use, the two strategies turn out to be indistinguishable. Thus, controlled trading "avoids allocational problems" only in the sense that it treats established emission levels as property rights.

I am certainly chastened by Holm, who has chosen to provide "more of the story" on the scientific debate that I considered too technical to pursue at length. His penetrating revelations consist of three sentences, two of which appear to be vague references to the studies which are in fact cited in my article's updating footnote—which he evidently failed to notice. I should add that these new studies, contrary to his assertion, make no reference to "serious doubt about the theory," as distinguished from uncertainty about the eventual level of ozone depletion. Nor does he mention that the NAS study assumed steady-state emissions whereas real world growth exceeds 7 percent annually. Nonetheless, continued scientific research does indeed seem warranted. Where did I say otherwise? But Holm's implication that such research will soon "prove or disprove the theory" demonstrates little understanding of the nature of scientific evidence. Moreover, why, in any event, is a production cap at existing levels inconsistent with careful monitoring of continued scientific research?

The other questions I am charged with having left unanswered are, in fact, the ones I raised in the article. Scarcity means higher prices and creates market impacts that are difficult to chart in advance. So does the elimination of any market externality, whether traditional regulatory strategies or an economic incentives approach is employed. A freeze at existing production levels no doubt would have a very modest effect on various CFC uses—contrary to Holm's dire warnings. I fail to see where he has shed any additional light on a difficult problem whose scientific, international, and domestic economic dimensions deserve serious policy consideration. ■

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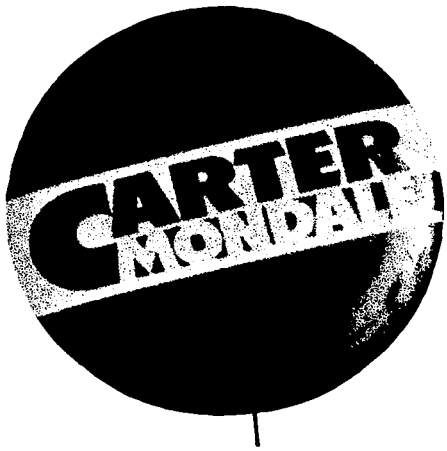

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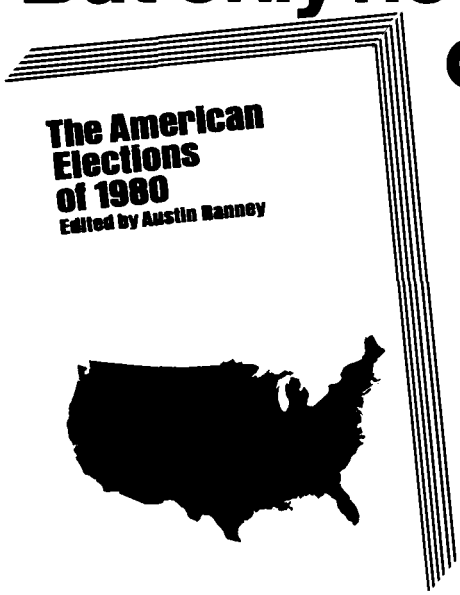

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